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Involuntary Bankruptcy and the Bona Fides of a Bona Fide Dispute

LAWRENCE PONOROFF*

INTRODUCTION

Under the Bankruptcy Reform Act of 1978,¹ the bulk of the substantive law controlling creditors' entitlement to involuntary bankruptcy relief was consolidated into section 303 of the Bankruptcy Code.² Two provisions of that statute are relevant for purposes of this Article. The first is section 303(b) which governs the issue of eligibility to file an involuntary petition. As originally drafted, it provided that, other than in a case involving a partnership debtor,³ authority to commence an involuntary case was limited to creditors holding non-contingent and unsecured claims against the debtor with an aggregate value of at least \$5,000.⁴

The other provision of interest is section 303(h)(1). It contains the first, and by far the more dominant, of the two alternative grounds⁵ upon which

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1. Pub. L. No. 95-598, 92 Stat. 2549 (1978) [hereinafter "Reform Act"]. Title I of the Reform Act was codified as 11 U.S.C. §§ 101-1330 (1982 & Supp. IV 1986). References in this Article to the "Bankruptcy Code" or to the "Code" are to Title 11 of the United States Code as amended through January 15, 1987 unless otherwise indicated. 11 U.S.C. (1982 & Supp. IV 1986).

2. 11 U.S.C. § 303.

3. Section 303(b)(3) of the Code contains special rules governing commencement of an involuntary case against a partnership. In addition to institution by unsecured claimholders, an involuntary case may be initiated by any one or more general partners of a partnership. In essence, any partnership bankruptcy commenced by less than all of the general partners is treated as an involuntary case. See *In re Memphis-Friday's Assocs.*, 88 Bankr. 821 (Bankr. W.D. Tenn. 1988).

4. 11 U.S.C. § 303(b)(1) (1982) (amended 1984). Refer to *infra* note 40 for the main text of this provision under the Reform Act. Note that under this formulation a secured claimholder is not disqualified from being a petitioning creditor. See *Paradise Hotel Corp. v. Bank of Nova Scotia*, 842 F.2d 47 (3d Cir. 1988). In fact, a partially secured creditor is not only eligible to join in the petition, but also, to the extent of the difference between the amount of its claim and the value of its collateral, to have its claim count towards the \$5,000 claims floor which the petitioners collectively must meet. See 11 U.S.C. § 506(a) (1982) regarding the distinction between secured and unsecured claims for bankruptcy purposes.

5. The other ground for relief, which is a carryover from prior law, requires a showing that a "custodian" was appointed or authorized to take possession of all or substantially all of the debtor's property within 120 days of the filing of the petition. See 11 U.S.C. § 303(h)(2) (1982). The term "custodian" is defined in 11 U.S.C. § 101(10) (1982). The incorporation of this provision essentially allows creditors who act promptly to preempt most state and other non-bankruptcy insolvency proceedings in favor of liquidation or reorganization under the Code. See H.R. REP. No. 595, 95th Cong., 1st Sess. 323-24 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6279-80.

involuntary relief may be granted once the jurisdiction of the bankruptcy court has been properly invoked under section 303(b).⁶ Under the Reform Act version of section 303(h)(1), if the debtor controverted the petition,⁷ relief could not be ordered against the debtor unless the petitioners could show that, as of the date of filing, the debtor was generally not paying its debts as they became due.⁸

In 1984, as part of the revisions to the Code effected by Title III of the Bankruptcy Amendments and Federal Judgeship Act of 1984,⁹ Congress amended the Reform Act's requirements for involuntary bankruptcy by inserting identical language in sections 303(b) and 303(h)(1) which excludes for both purposes claims and debts subject to a "bona fide dispute."¹⁰ These parallel amendments became effective immediately upon the enactment of the 1984 Act, and applied to all cases pending or filed after that date.¹¹

The legislative history of the 1984 Act makes clear that, in amending section 303, Congress was reacting to a concern that the threat of involuntary bankruptcy might be used as a tool to bludgeon a debtor into payment of dubious claims or satisfaction of obligations open to legitimate question.¹² At the same time, legislators hoped that these changes would resolve the ambiguity which had arisen in the case law under the Reform Act regarding the proper treatment of disputed debts in involuntary bankruptcies.¹³

6. The bankruptcy court's jurisdiction to consider the merits of an involuntary petition is invoked by the filing of a petition by the requisite number of creditors holding qualified claims in the required amount. See *In re All Media Properties, Inc.*, 5 Bankr. 126, 131 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981); see also *infra* notes 40-41 and accompanying text for discussion of the specific creditor qualification requirements under the Reform Act. At present, it is sufficient to observe that the relationship between §§ 303(b) and 303(h) operates essentially as follows: If the debtor is successfully able to challenge one or more creditors' standing under § 303(b), the petition is improper and the court never reaches the issue under § 303(h) of whether or not the facts support entry of an order for relief.

7. 11 U.S.C. § 303(h) (1982) provides, in pertinent part: "If the petition is not timely controverted, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed." *Id.* However, an involuntary case may only be commenced under Chapter 7 or 11 of the Code. 11 U.S.C. § 303(a) (Supp. IV 1986).

8. 11 U.S.C. § 303(h)(1) (1982) (amended 1984). The full text of § 303(h)(1) under the Reform Act is reprinted *infra* note 43.

9. Pub. L. No. 98-353, 98 Stat. 333 (1984) [hereinafter "1984 Act"].

10. See § 426(b) of the 1984 Act.

11. Section 553(b) of the 1984 Act dealt specifically with the effective date of the amendments made by § 426(b). See also *In re Busick*, 831 F.2d 745, 747-48 (7th Cir. 1987) (Congress intended the 1984 amendments to § 303 to become effective immediately as of the date the 1984 Act was passed: July 10, 1984.).

12. See *infra* note 99 and accompanying text for citation and discussion of the relevant legislative history to the 1984 Act.

13. Prior to the 1984 Act, the courts were divided over the issue of whether the existence of a good faith dispute was sufficient to either bar a creditor from eligibility to seek involuntary relief or exclude a debt from among the count of the debtor's unpaid obligations, or both. In part, this discord could be attributed to the absence of specific statutory guidance on the matter. Case law under the Reform Act is reviewed *infra* notes 52-98 and accompanying text.

One of the purposes of this Article is to demonstrate that an unfortunate and ironic by-product of the 1984 Act's amendments to section 303 has been the replacement of prior judicial disagreement over the treatment of disputed debts with an even greater divergence of opinion over the guidelines for identifying the presence or absence of a bona fide dispute. It will also be argued that, without appreciably enhancing debtors' protections from abusive filings, the statutory exclusion of disputed debts from involuntary bankruptcy analysis has tilted the balance in contested cases so as to unduly restrict access to involuntary bankruptcy relief and, thereby, unfairly limit its utility as a creditors' remedy. Finally, this Article will suggest an alternative approach for analyzing the bona fides of a disputed claim under sections 303(b) and 303(h)(1) based on the premise that the relevant standards should differ depending upon the context in which the issue arises.

I. BACKGROUND

A. *Early History*

The creditor qualification requirements and the appropriate circumstances for relief under section 303 ultimately must be evaluated against the backdrop of the essential purposes sought to be served through involuntary bankruptcy. Therefore, it is necessary to begin with an understanding of the historical antecedents to the current Code provisions.

Initially, it is important to appreciate that, while widely regarded as a "debtor's remedy," federal bankruptcy law does not really take sides. To the contrary, providing creditors with a more efficient and equitable method of debt collection has always been at least as important an objective of bankruptcy policy as providing debtors with relief from burdensome debt.¹⁴ Consequently, when debtor or creditor conduct threatens to unfairly deplete value, and thereby undermine equal treatment of similarly positioned creditors, core bankruptcy policy dictates that creditors be able to compel the liquidation or reorganization of the debtor's estate through a federal bankruptcy proceeding.¹⁵

14. For example, Dean Jackson describes bankruptcy law, at its core, as a collectivized debt-collection device for claimants of an insolvent debtor which exists as an alternative to "state grab" remedies. As such, he observes that, when measured from the perspective of the creditor body as a whole, bankruptcy represents a superior method for maximizing the total pool of assets available for distribution under the mandatory scheme of bankruptcy priorities. T. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 7-19 (1986). See also Jackson & Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditor's Bargain*, 75 VA. L. REV. 155 (1989), in which the authors expand on the original creditor's bargain explanation of the bankruptcy system to take into account the hypothetical agreement of creditors to share in the risks of business failure.

15. The circumstance most frequently motivating involuntary filings is the making by the debtor of a large, preferential transfer of property to a single creditor, resulting in a net depletion of assets available to satisfy the claims of remaining creditors. See generally S. SNUDER & L. PONOROFF, *COMMERCIAL BANKRUPTCY LITIGATION* § 5.06 (1989).

In fact, the earliest bankruptcy law in the United States¹⁶ conformed with the prevailing English practice at the time¹⁷ in that it was exclusively a creditors' tool, and not a means for a debtor to voluntarily seek relief through discharge.¹⁸ Subsequent national legislation in 1841 and 1867 provided for voluntary debtor filings and the discharge of debts. However, also allowing creditors under certain circumstances to initiate an involuntary proceeding against the debtor was an idea that persisted throughout the development of federal bankruptcy law during the nineteenth century.¹⁹

B. *The 1898 Act*

Bankruptcy law for most of this century was governed by the National Bankruptcy Act of 1898, which survived until repealed by the Reform Act.²⁰ The Bankruptcy Act established strict and detailed conditions which creditors were required to satisfy in order to compel an involuntary bankruptcy administration. As to the threshold issue of standing to properly initiate a case, the Bankruptcy Act required that the petitioning creditors be the holders of "provable claims" against the debtor. The claims had to be non-contingent as to liability and certain in amount, aggregating to at least \$500 in excess of the value of any security held by such creditors.²¹ The notion of a "provable claim"²² had a connotation different from what one might

16. The first national bankruptcy act was passed by Congress in 1800, 2 Stat. 19 (1800), and applied only to traders and other intermediaries. It was repealed three years later. 2 Stat. 248 (1803). See generally A. SELVERSTONE, *BANKRUPTCY AND REORGANIZATION* 1 (1940); C. WARREN, *BANKRUPTCY IN THE UNITED STATES* 13-14 (1935).

17. For discussion of early English bankruptcy law, which formed the pattern for the first federal bankruptcy act, see Countryman, *A History of American Bankruptcy Law*, 81 COM. L.J. 226 (1976).

18. The relatively recent origins of voluntary bankruptcy, and the historical developments in the first half of the 19th Century which accounted for its adoption at the federal level, are insightfully analyzed in McCoid, *The Origins of Voluntary Bankruptcy*, 5 BANKR. DEV. J. 361 (1988). See also C. WARREN, *supra* note 16, at 49-92.

19. See Bankruptcy Act 1841, chs. 1, 4, 5, 9, 5 Stat. 440, 441-43, *repealed by* Act of March 3, 1843, ch. 82, 5 Stat. 614; Bankruptcy Act 1867, ch. 176, §§ 11, 37, 39, 14 Stat. 521, 535-36, *repealed by* Act of June 7, 1878, 20 Stat. 99. For detailed discussion of national bankruptcy law during this period, see generally C. WARREN, *supra* note 16.

20. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, *as amended by* 52 Stat. 840 (1938) (*repealed* 1979) [hereinafter "Bankruptcy Act" or "Act"].

21. See Bankruptcy Act § 59b. Like the Bankruptcy Code, the Bankruptcy Act fixed the number of creditors required to join in an involuntary petition in order to invoke the jurisdiction of the court by reference to whether or not the debtor had twelve or more arms-length creditors. Compare 11 U.S.C. § 303(b)(1), (2) (1982 & Supp. IV 1986) with Bankruptcy Act §§ 59b, 59e. See also *infra* note 41 and accompanying text. Under the Act, every natural person, except a wage-earner or a farmer, and most business corporations, could be forced into a bankruptcy proceeding. See Bankruptcy Act § 4b.

22. The concept of provability was relevant for a variety of purposes under the Bankruptcy Act beyond the question of who could be a valid petitioning creditor. The Act also employed it in determining whether particular creditors would be entitled to share in distributions in a bankruptcy case, Bankruptcy Act §§ 65c, 57d, and whether a claim would be affected by the debtor's discharge, Bankruptcy Act § 17a.

expect. Rather than requiring the establishment of the merits of a contested claim by proper evidence, the concept of provability turned wholly on the nature and subject matter of the claim. The Act enumerated nine separate classes or types of claims that would be considered "provable" for purposes of a bankruptcy case.²³

Although contingent debts and contingent contractual liabilities were generally included among the categories of provable claims under the Act,²⁴ contingent claim holders were statutorily proscribed under section 59b from compelling the debtor's bankruptcy. Moreover, proof of a valid defense to an alleged claim was generally sufficient to render the claim not provable under the Act.²⁵ Thus, as a practical matter, a claim had to be non-contingent, unliquidated,²⁶ and, by and large, undisputed, before it conferred on its holder standing to seek involuntary bankruptcy against the debtor.

An even greater impediment to the widespread use of the involuntary bankruptcy remedy under the Act was the standards to which petitioning creditors were held in order to prevail on the merits. Before a debtor could be adjudged a bankrupt, the Act required that the petitioning creditors prove that the debtor had committed one or more of the six enumerated "acts of bankruptcy."²⁷ Many of these acts, even if committed, were difficult to detect and toilsome to prove. Often, this meant that by the time creditors were successful in demonstrating the need for bankruptcy protection, assets

23. Bankruptcy Act § 63a.

24. Bankruptcy Act § 63a(8). However, although provable, by virtue of § 57d contingent debts and claims would not be allowed unless they were capable of reasonable estimation.

25. For example, under the Bankruptcy Act, tort claims were only deemed provable if they had been reduced to judgment or if the claimant had filed an action on the claim prior to the filing of the petition in bankruptcy. Bankruptcy Act § 63a(1), (7); *see also In re All Media Properties*, 5 Bankr. 126, 134 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981), and authorities cited therein. *But see* Bankruptcy Act § 63a(4) which provided that unadjudicated claims founded upon an open account or an express or implied contract could be proved and allowed against the estate.

26. Actually, the original version of § 59b of the Bankruptcy Act only required that the petitioners' claims be provable. The Chandler Act, ch. 575, 52 Stat. 840, 868 (1938), added the requirement that the claims be "fixed as to liability and liquidated as to amount." The term "fixed" was changed to "non-contingent" by the Act of July 7, 1952, Pub. L. No. 82-456, 66 Stat. 420, 425. The Act of September 25, 1962, Pub. L. No. 87-681, 76 Stat. 570, 571, dropped the reference to "liquidated" and added language that a claim or claims, if unliquidated, shall not be counted in computing the number and the aggregate amount of the claims of the creditors joining in the petition, if the court determines that the claim or claims cannot be readily determined or estimated to be sufficient, together with the claims of the other creditors, to aggregate \$500, without unduly delaying the decision upon the adjudication.

Id. For more extensive discussion on the history of § 59b, see Kennedy, *Bankruptcy Legislation of 1962*, 4 B.C. IND. & COM. L. REV. 241, 250 (1963).

27. Bankruptcy Act § 3a classified the "acts of bankruptcy" as follows: (1) Fraudulent conveyances; (2) Preferential transfers, while insolvent; (3) Liens through legal proceedings, while insolvent; (4) Assignment for the benefit of creditors; (5) Appointment of a receiver, while insolvent or unable to pay debts; and (6) Written admission of inability to pay debts and willingness to be adjudged bankrupt. 30 Stat. 546 (1898).

that were part of the estate had been dissipated or concealed. The rigor of the petitioner's task was magnified by the fact that the court only had jurisdiction over the involuntary petition if it was filed within four months after commission of the offending act of bankruptcy.²⁸

An element common to four of the six designated acts of bankruptcy²⁹ was proof of insolvency either at the time the act was committed or, in the case of a fraudulent transfer,³⁰ at any time thereafter and at the time of filing.³¹ For this purpose, the Act defined insolvency in the "balance sheet" sense as assets, at fair valuation, insufficient in amount to satisfy liabilities.³² In addition to the fact that such a determination often could not be made without the benefit of information exclusively in the possession of the debtor, this requirement also compounded creditors' dilemma by introducing difficult issues of valuation into the process.

Professor MacLachlan, an influential contemporary commentator, vehemently complained that the Act's failure to embrace the alternative "equity sense" measurement of insolvency—inability to pay debts as they mature³³—unfairly prejudiced creditors, without any compensating benefit to debtors, by detrimentally delaying creditors' rights to seek and obtain involuntary bankruptcy relief until in many cases the debtor's financial condition had deteriorated beyond the point of no return.³⁴ He further observed that the

28. See Bankruptcy Act § 3b.

29. Technically, where the act of bankruptcy consisted of either an assignment for the benefit of creditors or a consent to bankruptcy, proof of insolvency was not required. Bankruptcy Act § 3a(4), (6). Practically speaking, however, in most cases it would be present anyway. Additionally, under § 3a(6), the debtor was required to admit an inability to pay its debts as well as its willingness to be adjudged a bankrupt. Thus, at some level, insolvency was a factor in virtually all involuntary bankruptcy cases.

30. Bankruptcy Act § 3a(1).

31. If the creditor alleged the first act of bankruptcy (fraudulent conveyance), there was no requirement that the debtor be insolvent at the time of the conveyance. However, it was necessary that the debtor be insolvent at the time of filing. See Bankruptcy Act § 3c, which provided a complete defense to an involuntary petition based upon proof of the alleged bankrupt's solvency at the time of the filing against him. Of course, this defense was limited to cases involving creditor petitions alleging a fraudulent conveyance as the basis for having the debtor adjudged an involuntary bankrupt. See *West v. Lea Co.*, 174 U.S. 590, 592-98 (1899).

32. See Bankruptcy Act § 1(19).

33. Equity sense insolvency was recognized and employed under the Bankruptcy Act in a number of contexts, including as an alternative element to the balance sheet insolvency requirement under the fifth act of bankruptcy, Bankruptcy Act § 3a(5), and in connection with the eligibility requirements for Railroad Reorganizations, Bankruptcy Act § 77a, Municipal Debt Readjustments, Bankruptcy Act § 323, Real Property Arrangements, Bankruptcy Act § 423, and Wage Earner's Plans, Bankruptcy Act § 623.

34. See J. MACLACHLAN, *HANDBOOK OF THE LAW OF BANKRUPTCY* 12-14 (1956). Professor MacLachlan argued that the Act's stubborn insistence on defining insolvency in the balance sheet sense of assets at fair valuation less than debts, not only reflected a misguided solicitude for the protection of debtors, but ignored the commercial reality that the downward spiral into financial oblivion inevitably begins when the debtor fails to pay its debts. *Id.* at 56-58; see also McCoid, *The Occasion for Involuntary Bankruptcy*, 61 AM. BANKR. L.J. 195 (1987) (addressing the issue of which definition of insolvency represents the most appropriate standard for involuntary bankruptcy).

practical consequence of requiring that an act of bankruptcy be established, particularly when coupled with the Act's adoption of the balance sheet test of solvency, was "a weakening of the bankruptcy law in relation to its important function of doing equity between creditors."³⁵

II. THE BANKRUPTCY REFORM ACT

Over time, the array of barriers which the Bankruptcy Act constructed in the path of creditors desiring to initiate an involuntary bankruptcy case came under increasingly heavy criticism.³⁶ In 1970, Congress established the Commission on Bankruptcy Laws of the United States ("Bankruptcy Commission") to "study, analyze, evaluate and recommend changes to [existing bankruptcy law]."³⁷ The Bankruptcy Commission's work served as the foundation for several proposed bankruptcy reform bills, including the bill that was eventually enacted into law in 1978.

In its 1973 report,³⁸ the Bankruptcy Commission responded sympathetically to the complaints voiced by Professor MacLachlan and others regarding the unhappy state of involuntary bankruptcy under the Act. It recommended a thorough overhaul of the current system for involuntary relief, including abandonment of the "complex, litigation-producing constraints" which had accounted for widespread "creditor dissatisfaction and lack of interest in the bankruptcy system."³⁹ Accordingly, in the original drafting of the Bankruptcy Code, the standards for involuntary bankruptcy were relaxed dramatically by eliminating many of the technical requirements and difficult issues of proof which had characterized the practice and procedures under the Bankruptcy Act.

In terms of jurisdictional prerequisites, section 303(b) expunged any reference to provability and, except to the limited extent of establishing the minimum \$5,000 claims amount requirement, included the holders of unliquidated claims within the ambit of entities eligible to petition for involuntary bankruptcy relief.⁴⁰ Section 303(b) also left intact the Act's rule that

35. J. MACLACHLAN, *supra* note 34, at 57.

36. See, e.g., *id.* at 53-65; Trost & King, *Congress and Bankruptcy Reform Circa 1977*, 33 BUS. LAW. 489, 504-05 (1978); Morgan, *Section 59b of the Chandler Act: An Impediment to Involuntary Bankruptcy Proceedings*, 37 ILL. L. REV. 215 (1943).

37. Pub. L. No. 91-354, 84 Stat. 468 (1970).

38. COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 1 (1973). The Report was issued in two parts: Part I contained findings and recommendations, and Part II proposed a reform bill [hereinafter Part I of this report referred to as BANKRUPTCY COMMISSION REPORT].

39. BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 186-88.

40. The Reform Act version of what was originally codified in 1979 as 11 U.S.C. § 303(b)(1) read, in pertinent part, as follows:

An involuntary case against a person is commenced by the filing with the

the required number of petitioning creditors would be reduced from three to one if the total of the debtor's unsecured creditors (exclusive of certain categories of creditors considered sympathetic to the debtor) numbered less than twelve.⁴¹ Additionally, the Code limited the category of persons exempt from involuntary bankruptcy to farmers and not-for-profit corporations.⁴²

Concerning the grounds for relief, the Reform Act totally abandoned the earlier requirement that the debtor be adjudicated as having committed an act of bankruptcy. Instead, section 303(h)(1) permitted proof of equity insolvency—defined as the debtor's general failure to pay its debts as they become due—as alone a sufficient basis for involuntary relief.⁴³ Therefore, the Reform Act appreciably lightened the burden for creditors seeking to establish entitlement to involuntary relief and, for that reason, facilitated

bankruptcy court of a petition . . .

(1) by three or more entities, each of which is . . . a holder of a claim against such person that is not contingent as to liability . . . if such claims aggregate at least \$5,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims.

Id.; see also 11 U.S.C. § 101(4) (1982) (encompassing within the definition of a "claim," any right to payment, without regard to whether or not such right has been reduced to judgment, and expressly inclusive of unliquidated, unmatured, contingent and disputed rights to payment).

41. 11 U.S.C. § 303(b)(2) (1982). The categories of creditors excluded from the count include: (1) employees of the debtor; (2) "insiders" of the debtor, as defined in 11 U.S.C. § 101(30) (Supp. IV 1986); and (3) creditors having received a transfer or interest in property of the debtor that is avoidable by the trustee. See also FED. R. BANKR. P. 1003(b) (liberal rules for the post-filing joinder of petitioners where the debtor alleges the existence of twelve or more creditors in response to a single creditor petition).

42. See 11 U.S.C. § 303(a) (1982) (amended to include "family farmers" by 11 U.S.C. § 101(18) (1986)). Compare Bankruptcy Act, *supra* note 20, § 4b.

43. The Reform Act version of what was originally codified in 1979 as 11 U.S.C. § 303(h)(1) read as follows: "The Court shall order relief against the debtor in an involuntary case . . . only if (1) The debtor is generally not paying such debtor's debts as such debts become due."

Note that this formulation of equity insolvency differs from the test of equity insolvency as it had been used under the Bankruptcy Act because it is satisfied upon a showing that the debtor generally is not paying its debts instead of requiring proof of an inability to pay. See *supra* note 33 and accompanying text for discussion of equity sense insolvency under the Act.

The language in § 303(h)(1), as originally enacted, represented a compromise between the House and Senate versions of the Reform Act. See 124 CONG. REC. 33,992-93 (1978) (statement of Sen. DeConcini) reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 6505, 6510. The House version of § 303(h)(1) focused on the "inability" of the debtor to meet its obligations as they come due. See H.R. REP. NO. 595, 95th Cong., 2d Sess. 323 (1978), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6280. The original Senate version, on the other hand, contemplated either the debtor's inability or the debtor's actual failure to "pay a major portion of his debts as they become due." S. REP. NO. 989, 95th Cong., 2d Sess. 34 (1978), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5820. The final version of § 303(h)(1), therefore, embodied a much more liberal standard than anything which had been conceived under the Act. See *In re Hill*, 5 Bankr. 79, 82-83 (Bankr. D. Minn. 1980) (ability to pay is not a direct factor in determining whether or not a debtor is "generally not paying" its debts for purposes of adjudicating an involuntary petition), *aff'd*, 8 Bankr. 779 (Bankr. D. Minn. 1981). See generally *infra* notes 80-82 and accompanying text for further discussion of the standards which the courts have used for determining when a debtor is generally not paying its current debts.

the speed with which such relief might be gained. Also, since equity insolvency may exist while the debtor is still fully solvent in a balance sheet sense,⁴⁴ under the Reform Act creditors no longer would have to anxiously endure the squandering or secreting away of a debtor's assets, or helplessly watch one creditor secure an unfair advantage over others, while awaiting satisfaction of the Act's formalities regulating access to bankruptcy protection.⁴⁵

Under the Reform Act, neither sections 303(b) nor 303(h)(1) spoke directly to the manner in which disputed debts were to be handled in ascertaining a petitioning creditor's standing and whether or not the debtor was generally paying its debts as they came due. Moreover, the legislative history provided no guidance. However, Code definitions lent support for the proposition that even a claim disputed by the debtor in good faith was sufficient to vest its holder with authority to file for involuntary relief and that, if matured, the same disputed claim could be counted among the debtor's unpaid debts for purposes of determining whether the debtor was insolvent. Specifically, the Code's definition of a "claim" for bankruptcy purposes unequivocally included both disputed and contingent obligations.⁴⁶ Like its Bankruptcy Act predecessor, section 303(b) then excluded any creditor whose claim against the debtor was "contingent as to liability" from joining in an involuntary proceeding.⁴⁷ However, the statute contained no comparable limitation on the rights of creditors holding disputed claims. While section 303(h)(1) was worded in terms of the payment of "debts" rather than claims, the Code defined the term "debt" as "liability on a claim,"⁴⁸ thus arguably backing into the same broad definition.⁴⁹

The foregoing construction of the Code as originally enacted seemed to support a rule of presumptive inclusion of disputed debts under section 303. This result was not only justifiable under the actual wording of the Code

44. Ordinarily, such a condition would be attributable to either the debtor's illiquidity due to poor cash flow management or malfeasance in the timely payment of current obligations.

45. This ability to obtain a prompt determination on an involuntary petition was precisely the goal which the Bankruptcy Commission identified as central to any reform of involuntary bankruptcy law and procedure. See BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 186-87. The Code's adoption of the non-payment of debts as the ultimate controlling fact in determining whether a debtor should be adjudged a bankrupt also served to vindicate Professor MacLachlan, who had lobbied vigorously for just such a change in the law in order to maximize and more equitably apportion value for creditor interests. J. MACLACHLAN, *supra* note 34, at 58, 63-64.

46. See 11 U.S.C. § 101(4) (1982), discussed at *supra* note 40.

47. The exclusion in § 303(b) for contingent claims offered further support for the view that a creditor's standing was not invalidated by a legitimate dispute inasmuch as § 101(4) identified both contingent *and* disputed obligations as falling within the broad ambit of a "claim" for Code purposes.

48. See 11 U.S.C. § 101(11) (1982).

49. See *infra* note 177 for discussion of conflicting views on whether or not the meaning for Bankruptcy Code purposes of the terms "claim" and "debt" are coextensive.

provisions, but was also consistent with the drafters' overall goal of liberalizing the rules governing involuntary petitions. Such an expansive interpretation might have been criticized for creating an unreasonable risk that involuntary bankruptcy would be used to coerce payments of specious claims or debts disputed in good faith. However, proponents of a broad rule of inclusion might have forcefully responded that the sanctions in section 303(i) for filings undertaken in bad faith provided a more direct, measured, and effective deterrent to such abusive practices than the imposition of limitations on the rights of disputed claimholders.⁵⁰ Nevertheless, between 1979 and 1984, the courts, while certainly not in agreement over what to do with disputed debts under section 303, never truly adopted a posture of total indifference toward debts subject to an honest squabble.⁵¹ Moreover, during this period the courts adopted very different approaches to the question of how to treat disputed debts depending on whether the issue was a claimholder's qualifications to maintain suit or instead was the existence of a sufficient basis for relief in that suit once it had been properly initiated.

III. THE PRE-1984 ACT CASE LAW

A. *Disputed Debts Under Section 303(b)*

The predominant approach taken by the courts in dealing with disputed debts under the new Bankruptcy Code's eligibility standards for seeking involuntary relief was enunciated and crisply illustrated in *In re All Media Properties, Inc.*⁵² In that case, which actually involved separate petitions against two affiliated companies,⁵³ the debtors had sought to disqualify the holders of certain unmatured and contested claims on the grounds that such claims failed to satisfy the statutory requirement that a petitioner's claim be "not contingent as to liability." The court used the occasion to reflect

50. 11 U.S.C. § 303(i) (1982 & Supp. IV 1986) had no direct counterpart under the Bankruptcy Act. Moreover, there is no doubt but that its adoption under the Code was in fact intended to serve as a counterweight to the Code's more liberal provisions regarding access to involuntary relief. See BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 190 (discussing the court's discretion to award fees and damages as a means of protecting against creditor abuses without compromising creditors' right to equal treatment *inter se* through bankruptcy relief); see also *In re All Media Properties, Inc.*, 5 Bankr. 126, 135 (Bankr. S.D. Tex. 1980) (wherein the court accepted precisely this argument concerning the relationship between §§ 303(b) and 303(i)), *aff'd*, 646 F.2d 193 (5th Cir. 1981) (discussed *infra* notes 52-60 and accompanying text).

51. The situation was exacerbated by the fact that a debt might be "disputed" for a variety of different causes ranging from legal defenses, defenses on the merits and defenses as to amount, on the one hand, to counterclaims, setoffs and claims for recoupment, on the other.

52. 5 Bankr. 126 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981).

53. The two cases were consolidated for hearing upon agreement of the parties because of the similarity of the issues involved. *Id.* at 131.

on the significance of the omission from section 303(b) of an exclusion for the holders of unmatured, disputed or unliquidated claims.⁵⁴ Contrasting the more complex procedures and requirements under the Bankruptcy Act, including the more restrictive language of section 59b, the court concluded that section 303 manifested a clear legislative intent to simplify the issues addressed upon the filing of an involuntary petition and, thereby, expand creditors' access to bankruptcy relief.⁵⁵

Given these purposes, the *All Media* court held that a claim is not contingent merely because it is uncertain as to amount, so long as liability is absolutely fixed.⁵⁶ By the same token, the court admonished that a legal obligation is not rendered contingent because a dispute as to liability arises after it is incurred.⁵⁷ The terms "contingent" and "disputed" are not synonymous. Rather, the court resolved that the merits or demerits of the debtor's alleged defenses to a creditor's claim are largely collateral to the issue of the court's subject matter jurisdiction over an involuntary petition. Therefore, consideration of the validity of disputed but non-contingent claims would be deferred until subsequently raised, if at all, by proper proceedings in the ensuing bankruptcy administration.⁵⁸

While at first blush the *All Media* decision appeared to embrace an unqualified rule that counterclaims and defenses to a petitioning creditor's claim are wholly irrelevant for purposes of section 303(b), a careful reading of the case reveals that the court stopped short of slamming the door completely shut. In concluding its analysis of the impact of a bona fide dispute under section 303(b), the court stated:

If there is a bona fide dispute of either fact or law then the holder would not be disqualified from being a petitioning creditor since he would be the holder of a disputed claim, but not one that is contingent

54. The Code has gone much further in allowing holders of claims to bring involuntary petitions; only holders of claims that are contingent as to liability are denied the right to be petitioning creditors. It is significant that holders of unmatured, disputed and unliquidated claims are not specifically barred from being petitioning creditors. *Id.* at 132.

55. *Id.* at 135 (less restrictive jurisdictional requirements for bringing an involuntary petition are consistent with the pervasive jurisdiction given to the bankruptcy courts under the Bankruptcy Reform Act of 1978).

56. *Id.* at 133. The court identified the liability of a guarantor on a promissory note as a "classic case" of contingent liability—that being one in which the debtor would only be called on to pay upon the happening of an extrinsic event. Also, although none of the claims at issue arose in tort, the court suggested that a tort claim for negligence might rightly be characterized as contingent unless and until reduced to judgment. *Id.* See *infra* note 73 for additional discussion of the question of contingency in the context of tort claims.

57. *Id.* The court concluded that such a claim—i.e., one arising out of the sale of a defective product—is disputed but not contingent since a legal obligation arose at the time of sale.

58. *Id.* at 134. Essentially, the court interpreted § 303(b)(1) as pegging jurisdiction in an involuntary case to filing by the requisite number of holders of claims, and not necessarily holders of *valid* claims. Of course, should the petition be dismissed or withdrawn, the bankruptcy court would be spared from ever having to resolve the dispute over the claim.

as to liability within the definition fashioned above. On the other hand, if the debtor can establish to a certainty that the debt is barred or that the amount is other than alleged without substantial factual or legal questions, then the alleged debt should not be considered and the holder would not be qualified to be a petitioning creditor in the amount claimed.⁵⁹

Thus, the *All Media* court left open the possibility that, under the right circumstances, a meritorious defense could be used to invalidate a petitioning creditor's claim provided that such defense could be established clearly and without the need to resort to extensive proof.⁶⁰

Most of the other courts which considered the standing of a creditor holding a non-contingent but disputed claim acceded in the liberal interpretation given to section 303(b) by the *All Media* court.⁶¹ For example, the Seventh Circuit concluded that the existence of defenses which, if established, would eliminate liability on the debt, did not impair the holder's standing to petition for involuntary bankruptcy.⁶² Nevertheless, a few courts expressed reservations over this broad construction of qualified claims under section 303(b).⁶³ Moreover, the process of drawing the line between a

59. *Id.* at 135-36.

60. The court justified drawing this distinction between complex and non-complex defenses on the basis of both the debtor's and creditors' interest in a prompt resolution of an involuntary petition. *Id.* at 134.

61. For examples of cases holding that the assertion of a counterclaim or defense to a claim does not render the claim "contingent as to liability," see *In re Dill*, 30 Bankr. 546, 549 (Bankr. 9th Cir. 1983) (a claim is only contingent if liability is dependent on some future event that may never happen), *aff'd*, *Semel v. Dill (In re Dill)*, 731 F.2d 629 (9th Cir. 1984); *In re First Energy Leasing Corp.*, 38 Bankr. 577, 582 (Bankr. E.D.N.Y. 1984) (under prevailing authority, holders of disputed claims are eligible to be involuntary petitioners); *In re Tampa Chain Co.*, 35 Bankr. 568, 575 (Bankr. S.D.N.Y. 1983) (resolution of disputes should be left for a later time); *In re R.N. Salem Corp.*, 29 Bankr. 424, 428 (Bankr. S.D. Ohio 1983) (the right to be a petitioning creditor does not depend on the existence of an undisputed claim); *In re McMeekin*, 16 Bankr. 805, 807 (Bankr. D. Mass. 1982) (a creditor is not disqualified from joining in an involuntary petition because its claim is disputed); *In re Gill Enterprises*, 15 Bankr. 328, 331 (Bankr. D.N.J. 1981) (creditors with accrued but disputed claims are qualified to file an involuntary petition); *McNeil v. United States Fidelity & Guar. Co. (In re McNeil)*, 13 Bankr. 434, 436 (Bankr. E.D. Tenn. 1981) (the fact that the debtor disputes a petitioner's claim and has asserted a counterclaim against it does not make the claim contingent); *In re Duty Free Shops Corp.*, 6 Bankr. 38, 39 (Bankr. S.D. Fla. 1980) (the debtor's refusal to concede a claim's validity does not invalidate its holder from seeking involuntary relief); see also Taube, *Involuntary Bankruptcy: Who May Be a Petitioning Creditor?*, 21 Hous. L. Rev. 339 (1984).

62. *In re Covey*, 650 F.2d 877, 881-82 (7th Cir. 1981). As was true in other cases as well, the court cited *All Media* for the proposition that disputed claimholders were *unqualifiedly* eligible to be involuntary petitioners.

63. Most notably, Judge Friendly, albeit in dictum, indicated his reluctance to accept the conclusion that "Congress intended . . . that a claim qualifies under § 303(b), when the claim is subject to serious dispute." *B.D. Int'l Discount Corp. v. Chase Manhattan Bank (In re B.D. Int'l Discount Corp.)*, 701 F.2d 1071, 1076 (2d Cir. 1983), *cert. denied*, 464 U.S. 830 (1983).

contingent claim and a disputed one was not always accomplished with great ease or consistency.⁶⁴

Standing in probably the greatest contradistinction to *All Media* was the bankruptcy court's opinion in *In re Kreidler Import Corp.*⁶⁵ In that case, the debtor objected to the standing of a creditor that had joined in the involuntary petition on the basis of an alleged counterclaim against such creditor which, if proven, would have completely setoff the amount of the creditor's claim.⁶⁶ Based on its examination of the record, the court concluded that the debtor's counterclaim had at least a bona fide factual basis and, accordingly, extinguished the creditor's claim as forming the basis for joinder in the involuntary petition.⁶⁷ Notably, the court in *Kreidler* also invalidated the claim of another petitioning creditor whom the court determined had received, and failed to surrender before the petition was filed, a voidable preference under section 547(b) of the Code.⁶⁸

64. See *infra* note 73 for citation of authorities using contingent analysis to bar certain claimholders from eligibility to seek bankruptcy relief; see also *First Energy Leasing*, 38 Bankr. at 582 (court observed the temptation to solve the dilemma over disputed debts by defining "contingent" in such a manner as to subsume "disputed" and "unmatured," but declined to do so absent more explicit legislative direction).

65. 4 Bankr. 256 (Bankr. D. Md. 1980).

66. *Id.* at 259. The essence of the counterclaim was for damages attributable to the alleged breach of a certain distribution agreement between the creditor (Slemons Leasing & Auto Rental) and the debtor. Coincidentally, the basis of Slemon's claim against the debtor was amounts due from the debtor under the same agreement. *Id.* Thus, while the facts are not entirely clear, the substance of the counterclaims might also have been characterized as offering a specific defense to liability on the creditor's claim. However, the court seemed to attach no relevance to the connection between the subject matter of the correlative claim and counterclaim. *Id.* This omission is significant since, as against another creditor (M.L. Alverson), the court brushed aside the debtor's counterclaim under a different distribution agreement on the basis that "disputed claims are nonetheless claims." *Id.* at 258.

67. *Id.* at 259.

68. *Id.* at 258-59. The court in *Kreidler* failed to satisfactorily explain why receipt of a preference should disqualify a creditor from validly intervening in an involuntary petition, citing only to a policy to that effect purportedly developed under the Act. *Id.* at 259. The conclusion is particularly suspect under the Code since, while § 303(b)(2) expressly excludes a claimant having received a preference from the calculation of whether the debtor's creditors number twelve or more, there is no indication in the language of § 303(b) or elsewhere that such a creditor, if it so chooses, is barred from validly joining in an involuntary petition.

In fact, it remains unclear whether receipt of a voidable transfer, or the debtor's promise to make a preferential transfer, should be treated as either tainting that creditor's standing under § 303(b) or eliminating such claim for purposes of the analysis under § 303(h)(1). Although that inquiry is beyond the scope of this Article, a persuasive case can be made for a negative response on both counts inasmuch as the net effect of a successful avoidance action is to place the preferred creditor in the same position as any other unsecured claimholder as of the time of filing. See 11 U.S.C. § 502(h) (Supp. IV 1986).

Also of note in *Kreidler* is the fact that the offending payment was made after the petition was filed and was thus only avoidable, if at all, under § 549 and not, as the court indicated, under § 547(b). Finally, since the "generally not paying" test under § 303(h)(1) must be applied as to the date of filing, the subsequent payment would be of no significance relative to whether or not grounds for involuntary relief existed. See *In re Molen Drilling Co.*, 68 Bankr. 840, 846 (Bankr. D. Mont. 1987).

While *Kreidler*, at first, might have been seen as establishing a major exception to the *All Media* approach to disputed debts when the debtor asserted a counterclaim of equal or greater magnitude against a creditor, such a perception would have been wrong. First of all, *Kreidler* was decided before *All Media*, and the *Kreidler* court expressly relied on pre-Code law in support of its conclusions.⁶⁹ In addition, subsequent courts harmonized the two decisions by pointing out that in *Kreidler* the parties had stipulated to the facts comprising the counterclaim.⁷⁰ Therefore, the debtor's counterclaim in *Kreidler* arguably presented precisely the sort of "open-and-shut" defense which the *All Media* court recognized might in fact serve to prevent a claimholder from validly joining in an involuntary petition. Later courts considering contested counterclaims thus perceived little difficulty in applying the *All Media* rationale of functionally separating the issues presented by the counterclaim from the issues presented by the petition.⁷¹

Therefore, prior to 1984, a debtor that sought to protest the validity of an involuntary petition on jurisdictional grounds by contesting a petitioning creditor's eligibility to file was relegated to attempting to define what might be in essence a disputed claim as being contingent as to liability. Of course, *All Media* had already formulated a fairly narrow construction of what constituted a contingent claim,⁷² so the task was a considerable one. However, it was not hopeless, and, on occasion, a bona fide defense or counterclaim to a petitioning creditor's debt might sneak back into the section 303(b) analysis under this guise.⁷³ Nonetheless, prior to the 1984

69. *Kriedler*, 4 Bankr. at 259 (citing *Harris v. Capehart-Farnsworth Corp.*, 225 F.2d 268, 270 (8th Cir. 1955)).

70. See, e.g., *Tampa Chain*, 35 Bankr. at 577 n.8; *In re North County Chrysler Plymouth*, 13 Bankr. 393, 398 (Bankr. W.D. Mo. 1981).

71. For example, in *In re Hill*, 5 Bankr. 79 (Bankr. D. Minn. 1980), *aff'd*, 8 Bankr. 779 (Bankr. D. Minn. 1981), the debtor challenged the standing of the petitioning creditor (to whom an indebtedness was indisputably owed) on the basis of alleged antitrust and other counterclaims still pending in state court at the time the petition was filed. In rejecting this challenge to the creditor's qualifications, the court stated: "The mere fact of the pendency of the undecided litigation with respect to defenses and claims is not directly relevant to the issues presented by the petition." *Id.* at 82.

72. *All Media*, 5 Bankr. at 133; see *supra* notes 56-57 and accompanying text.

73. While paying lip service to the narrow construction of contingent claims advanced by the court in *All Media*, several courts used contingent analysis, and the dictum in *All Media* regarding negligent torts, *id.* at 133 (see *supra* note 56), to find that various intentional torts and corporate veil-piercing claims were contingent as to liability as well as to amount unless and until reduced to final judgment. See, e.g., *In re Elsub Corp.*, 70 Bankr. 797, 808 (Bankr. D.N.J. 1987) (claims for discriminatory conduct and wrongful discharge invalidated as contingent); *In re Turner*, 32 Bankr. 244, 248-49 (Bankr. D. Mass. 1983) (alter ego and fraud claims are contingent pending a judicial finding of liability).

On the other hand, some courts gave the construction of non-contingent claims for purposes of § 303(b) an even more restrictive interpretation than that proposed in *All Media*. See, e.g., *Dill*, 30 Bankr. at 549 ("A tort claim ordinarily is not contingent as to liability; the events that give rise to the tort claim usually have occurred and liability is not dependent on some

Act, courts by and large resisted the temptation to complicate the litigation in involuntary cases by grafting detailed creditor qualification requirements on to the simple, direct language of section 303(b).⁷⁴

B. Disputed Debts Under Section 303(h)(1)

As noted earlier, if the debtor controverts an involuntary petition, the Code requires the petitioners to establish the existence of proper grounds for entry of an order of relief.⁷⁵ Under section 303(h)(1), relief is warranted if the petitioning creditors can show that, at the time of filing,⁷⁶ the debtor was insolvent in the "equity sense" of not satisfying current obligations as they became due.

Unlike a balance sheet analysis, ascertaining what constitutes a general failure to pay matured debts involves considering a myriad of factors relating to the debtor's overall financial condition and debt structure. These factors include analyses of liquidity and cash flow, the debtor's actual payment record and practices, and the materiality of the debtor's delinquencies in relation to the magnitude of the debtor's operations.⁷⁷ In other words, "equity sense" insolvency cannot be reduced to a mathematical formula.⁷⁸ Rather, the courts generally agree that the determination must be based on the facts and circumstances surrounding each case.⁷⁹ However, before Con-

future event that may never happen."); *In re Bowers*, 16 Bankr. 298, 301 (Bankr. D. Conn. 1981) (the debtor's guarantee obligation was held to be non-contingent even though the primary obligor had not actually defaulted in circumstances where the condition to liability appeared virtually certain to occur).

74. See, e.g., *In re Longhorn 1979-II Drilling Program*, 32 Bankr. 923, 927 (Bankr. W.D. Okla. 1983). In *Longhorn*, the court stated:

Thus, a tort claim accrues at the moment the course of events is first sufficiently ripe for suit. Lack of judgment does not affect the tort claim so as to make it contingent, but the judgment concerns only enforceability and payment of the claim. The contingency is whether the creditor will obtain a judgment, not whether he has a claim sufficient for an involuntary petition.

Id.; see also *Tampa Chain*, 35 Bankr. at 577 n.7 (disputes do not make claims contingent).

75. See *supra* notes 5-8.

76. See, e.g., *In re Molen Drilling Co.*, 68 Bankr. 840, 846 (Bankr. D. Mont. 1987) (the "generally not paying" test is applied as of the time of filing).

77. See *In re Caucus Distributions*, 83 Bankr. 921, 931 (Bankr. E.D. Va. 1988) (reviewing the various standards articulated by the courts for determining when a debtor is generally not paying its debts).

78. See, e.g., *Hayes v. Rewald (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.)*, 779 F.2d 471, 475 (9th Cir. 1985) (the determination of what constitutes "generally not paying" is not reducible to a simplistic formula); *In re Better Care, Ltd.*, 97 Bankr. 405, 407 (Bankr. N.D. Ill. 1989) (the test of "generally not paying" is not intended to be mechanically applied).

79. Compare *In re Dakota Lay'd Eggs*, 57 Bankr. 648 (Bankr. D.N.D. 1986) (setting forth the five-part test for determining "generally not paying" first articulated in *In re Gill Enters.*, 15 Bankr. 328, 332 (Bankr. D.N.J. 1981)) with *Boston Beverage Corp. v. Turner*, 81 Bankr. 738 (Bankr. D. Mass. 1987) (recommending that the issue be resolved by use of a two-step inquiry). See also *In re Better Care, Ltd.*, 97 Bankr. 405, 408-09 (Bankr. N.D. Ill. 1989)

gress specifically addressed the issue in 1984, it was unclear whether disputed debts and obligations were to be included in the examination of the debtor's practices regarding payment of matured debts. Moreover, the question of what to do with disputed debts in this context was more problematic than the parallel question of how to treat disputed debts for jurisdictional purposes under section 303(b). Unlike section 303(b), section 303(h)(1) had no specific counterpart under the Bankruptcy Act from which legislative intent might be inferred.⁸⁰

In *All Media*, after establishing that the existence of a good faith dispute did not defeat the court's jurisdiction under section 303(b), the court considered the effect of extending its reasoning to the issue of the petitioners' entitlement to relief. Noting the undesirability of debtors paying disputed debts solely to avoid being forced into bankruptcy, the court wasted little time in concluding that "where a debtor fails to pay a debt which is subject to a bona fide dispute that debt should not be considered a debt which has not been paid as it became due."⁸¹ Therefore, in the judgment of the *All Media* court, a petitioning creditor's debt might be counted for one purpose under section 303 (standing), but not for another (entitlement to relief); a perhaps subtle, but hardly revolutionary, concept that different standards may be applied to interpret a phrase when the consequences of the outcome differ.⁸² Of course, it may not always be the same debts which are considered

(creditor who had allowed late payments as a matter of course could not rely on such late payments to show the debtor was not paying its debts when due); *In re Laclede Cab Co.*, 76 Bankr. 687, 691-92 (Bankr. E.D. Mo. 1987) (established course of conduct and past practices are relevant to question of whether debtor's payments were timely); *In re Arriola Energy Corp.*, 74 Bankr. 784, 790 (Bankr. S.D. Tex. 1987) ("No one factor is necessarily determinative of whether, in fact, the Debtor is generally not paying debts as they become due."); *In re CLE Corp.*, 59 Bankr. 579 (Bankr. N.D. Ga. 1986) (examination of debtor's entire financial situation and debt structure may be necessary in making the determination).

80. See *supra* note 33 for citation of those provisions of the Bankruptcy Act where specific legal consequences were made to turn on the debtor's inability (as contrasted with the Code's focus on the debtor's failure) to pay debts as they matured. Where the test is phrased in terms of "inability to pay," a good faith dispute is arguably irrelevant. By contrast, when actual failure rather than inability is the standard, refusal to pay, even on the basis of allegedly legitimate defenses, has a direct bearing on whether or not the standard is satisfied. For discussion of the legislative history behind the drafting of § 303(h)(1), see *supra* note 43.

81. *All Media*, 5 Bankr. at 144; accord *In re First Energy Leasing*, 38 Bankr. at 584.

82. This idea of developing separate definitions in separate contexts under a statute based upon assumptions of what Congress intended in each case is consistent with the approach which some scholars have identified as the "narrow issue thinking" of the legal realist movement. For the proposition that separate definitions of the same term may develop under two different codes, see, for example, Lloyd, *Refinancing Purchase Money Security Interests*, 53 TENN. L. REV. 1, 79 n.369 (1985) (citing Llewellyn, *Some Realism About Realism—Responding to Dean Pound*, 44 HARV. L. REV. 1222, 1237 (1931)), and G. GILMORE, *THE AGES OF AMERICAN LAW* 82-83 (1977); see also Knippenberg, *Tacit Exclusion: Defining Code Terms Using Extraneous References*, 39 SYRACUSE L. REV. 1261 (1988).

An example of this concept, applied on an intra-code basis, can be found in the Bankruptcy Code's approach to the issue of valuation. Section 506 explicitly recognizes that the valuation

under the two analyses. A debtor may challenge entitlement to relief under section 303(h)(1) by contesting the validity of the claims of non-petitioning as well as petitioning creditors. By contrast, under section 303(b) only the claims of petitioning creditors are at issue.⁸³

In *In re Covey*,⁸⁴ the Seventh Circuit, while following *All Media* insofar as the section 303(b) analysis was concerned,⁸⁵ took a rather different approach to the disputed debts issue under section 303(h)(1). In large measure, the court saw its approach as controlled by the policies behind the Reform Act. The court emphasized that an important goal of the new Bankruptcy Code was the protection of creditors' interest through a prompt determination of the involuntary petition.⁸⁶ This necessarily implicated an interest in prompt resolution of the question of whether the debtor was generally not paying its current debts. Thus, while sympathizing with the *All Media* court's concern over undue coercion of the debtor, the *Covey* court felt that wholesale exclusion of disputed debts undermined an important goal of the new Bankruptcy Code—preserving creditors' rights to the debtor's property.⁸⁷ On the other hand, the strength of the competing policy interests dissuaded the court from adopting a per se rule of inclusion of disputed debts in the "generally not paying" analysis.⁸⁸

of property subject to a lien does not take place in a vacuum. 11 U.S.C. § 506(a) (1982). Rather, it makes a difference when and why the property is being valued. Thus, the legislative history of § 506(a) states that "a valuation early in the case in a proceeding under sections 361-363 would not be binding upon the debtor or creditor at the time of confirmation of the plan." S. REP. NO. 989, 95th Cong., 2d Sess. 68, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5854; see also H. REP. NO. 595, 95th Cong., 1st Sess. 356, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6312 ("Courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case."); *In re Wabash Valley Power Ass'n*, 77 Bankr. 991, 1005 (Bankr. S.D. Ind. 1987) ("[V]aluation of collateral is temporal, and must take into consideration both the reason the valuation is being made and the contemplated disposition or use of the collateral.") (citing 3 COLLIER ON BANKRUPTCY ¶ 506.04 (15th ed. 1989)).

83. In circumstances where the debtor contested the validity of the petitioning creditors' claims, the existence of a bona fide dispute which was insufficient to exclude a petitioning creditor's claim under § 303(b) might nevertheless have been excluded from the category of unpaid debts in ascertaining whether or not an order for relief would enter. In *All Media*, for example, the court excluded twelve obligations from among respondent-debtor Artlite Broadcasting Co.'s unpaid accounts for purposes of determining whether Artlite was generally not paying its debts on the basis that such accounts were disputed. *All Media*, 5 Bankr. at 144-46. Although the court did not specifically say so, presumably certain of the petitioning creditors' claims were among those disputed obligations.

84. 650 F.2d 877 (7th Cir. 1981).

85. See *supra* notes 61-62 and accompanying text.

86. 650 F.2d at 882-83 ("Creditors are entitled to a prompt resolution of the 'generally paying debts' question in order to prevent wasting of assets and in order to ensure that they receive all of their rights to the debtor's property afforded by the Code." (citations omitted)).

87. *Id.* at 883.

88. Specifically, the court stated: "The Coveys seem to ask for a universal rule excluding disputed debts from the calculation of 'generally paying debts.' But the policy considerations regarding such a rule do not unanimously support either exclusion or inclusion of disputed debts from the 'generally paying debts' calculation." *Id.* at 882.

To resolve the dilemma, the court in *Covey* formulated a set of detailed guidelines for the bankruptcy courts to apply on a case-by-case basis.⁸⁹ If the dispute concerned only the amount of the obligation, the bankruptcy court would be required, without further inquiry, to take the debt into account when evaluating whether the debtor was generally paying its current obligations.⁹⁰ However, if the debtor's dispute went to the existence or the validity of the claim, the court would need to go to the next step and consider the complexity of the litigation required to resolve the dispute. Should substantial litigation be needed to assess the merits of the dispute, the debt would simply be counted under section 303(h)(1).⁹¹ On the other hand, if the substance of the dispute could be adjudicated without extensive or complex litigation, the bankruptcy court would be obliged to weigh the creditors' interest in a prompt determination of the involuntary petition against the debtor's interest in avoiding bankruptcy, and then only reach the merits of the dispute when the debtor's interest predominated.⁹² In that event, inclusion or exclusion for purposes of section 303(h)(1) would be based on the court's actual assessment of the validity of the debtor's defenses. However, should the balance tip in the creditor's favor, the debt would, once again, automatically be considered unpaid for purposes of the "generally not paying" analysis, with the understanding that the court would defer determining the merits of the specific dispute until after entry of an order for relief.⁹³

On reflection, the standard prescribed in *Covey* for dealing with disputed debts under section 303(h)(1) bears a remarkable resemblance to the *All Media* test for establishing when holders of disputed claims could be counted for jurisdictional purposes under section 303(b). In each situation, the debtor's assertion of counterclaims or defenses would be eliminated as an issue in the court's disposition of the petition, except in certain exceptional and narrowly defined cases. Therefore, in most cases the debtor's disputes

89. Interestingly, the court suggested that its approach actually derived from the analysis in *All Media*. *Id.* at 883 n.8.

90. *Id.* at 883.

91. *Id.* This would also be true in cases where the "substantial litigation" question would itself require substantial litigation.

92. *Id.* The court also suggested that when "the scales seem equally balanced," the disputed debt should be considered unpaid and, therefore, be included against the debtor, since the Code clearly emphasizes the prompt resolution of involuntary bankruptcy cases. *Id.*

93. *Id.* at 883-84 (citing generally *All Media*, 5 Bankr. at 134-36). In sum, *Covey* determined that disputed debts would be excluded from the "generally not paying" calculation only when all of the following conditions are met:

- 1) the dispute is whether any claim exists, not merely regarding the amount of a claim; 2) the dispute can be examined without substantial litigation of legal or factual questions; and 3) the interests of the debtor in defeating an order of involuntary bankruptcy outweigh creditors' interests in achieving a somewhat more rapid determination of the involuntary bankruptcy question.

Id.

would be resolved, if at all, in the regular course of the debtor's ensuing bankruptcy administration.

Other courts, including panels of the Second and Ninth Circuits, were more equivocal than *Covey* in their willingness to consider disputed debts when making judgments about the debtor's payment practices under section 303(h)(1).⁹⁴ In *In re R.N. Salem Corp.*,⁹⁵ the district court openly criticized the *Covey* standard as too harsh. The court recommended that the circumstances which the *Covey* court viewed as conditions dictating inclusion of disputed debts should only be considered factors in a balancing process.⁹⁶ In other words, in all cases, "the essential question requires the Court to weigh the creditors' interest against those of the debtor."⁹⁷

The 1984 Act forestalled a judicial resolution of the disagreement between *Covey* and *All Media* concerning the impact of legitimately disputed debts under section 303(h)(1). Yet, in most of the cases decided up to that time courts recognized the wisdom of dealing with the disputed debts issue differently depending on whether it arose in the context of the court's jurisdiction to consider a petition for involuntary relief or in connection with the petitioner's entitlement on the merits to such relief. Consequently, by the time Congress was considering the 1984 amendments to the Code, the courts had not only already taken cognizance of the problem of disputed claims and debts under section 303, but had actually developed several methods of analysis to take account of such debts. Although certainly no consensus had developed as to which methodology was best, in virtually all instances the courts had designed approaches with an appreciation for the fact that it mattered why the question was being asked.

IV. THE 1984 AMENDMENTS

In 1984 Congress attempted to end the judicial disagreement over the treatment of disputed debts in involuntary proceedings. Section 426(b) of the 1984 Act amended section 303 of the Code by: 1) disqualifying under

94. In *B.D. Int'l Discount*, 701 F.2d at 1077, Judge Friendly, while deciding the case consistent with the *Covey* guidelines, nevertheless deferred general adoption of these guidelines as written or in modified form pending consideration of additional cases.

By contrast, the Ninth Circuit was even more hostile to *Covey*, suggesting it went too far in favoring creditors' interests, but sharing Judge Friendly's opinion that it was "a bit early in the day" to formulate such detailed guidelines. *Dill*, 731 F.2d at 632. Having declined to lay down a definitive rule, the court in *Dill* held that the bankruptcy courts should resolve the question of inclusion or exclusion of designated debts under § 303(h)(1) by a more simple, even-handed balancing of the creditors' interests against those of the debtor. *Id.*

95. 29 Bankr. 424 (Bankr. S.D. Ohio 1983).

96. *Id.* at 430.

97. *Id.* In this respect, the court's approach was essentially the same as the rule eventually enunciated by the Ninth Circuit in *Dill*. See *supra* note 94. In fact, the court in *Dill* cited *Salem* as an example of thoughtful, developing case law in the area. *Dill*, 731 F.2d at 632.

subsection (b) any entity holding a claim subject to a bona fide dispute from validly joining in an involuntary petition; and 2) purging from the category of unpaid debts which might count against the debtor under subsection (h)(1) debts subject to a bona fide dispute.⁹⁸ Thus, in one fell swoop, Congress seemed to eliminate the debate over the exclusion of disputed debts under section 303 in favor of debtors' interests.

The legislative history of these amendments is sparse; making the precise determination of congressional intent a difficult task. It is apparent, however, that Congress did not intend debtors to face the Hobson's choice of either paying genuinely disputed obligations or suffering the stigma of a bankruptcy filing. Senator Baucus, the proponent of the amendments, offered the following explanation from the floor:

[M]y amendment is designed to correct what I perceive to be an unintended inequity in the law of involuntary bankruptcies.

. . . .

The problem can be explained simply. Some courts have interpreted section 303's language on a debtor's general failure to pay debts as allowing the filing of involuntary petitions and the granting of involuntary relief even when the debtor's reason for not paying is a legitimate and good-faith dispute over his or her liability. . . .

. . . Under my amendment, the original filing of an involuntary petition could not be based on debts that are the subject of a good-faith dispute between the debtor and his or her creditors. In the same vein, the granting of an order of relief could not be premised solely on the failure of a debtor to pay debts that were legitimately contested as to liability or amount.

I believe this amendment, although a simply [sic] one, is necessary to protect the rights of debtors and to prevent misuse of the bankruptcy system as a tool of coercion. I also believe it corrects a judicial misinterpretation of existing law and congressional intent as to the proper basis for granting involuntary relief.⁹⁹

These comments are enlightening in several respects. First, they reflect a tacit rejection of the Bankruptcy Commission and the Reform Act's philosophy that the prospects for assessment of punitive damages and attorneys' fees under section 303(i) provided a sufficient deterrent against questionable or improper filings.¹⁰⁰ Second, in spite of earlier criticism that the weaknesses under the Bankruptcy Act's system for involuntary relief could be directly

98. Subsequent to the 1984 Act, § 303(b) read, in pertinent part, as follows: "An involuntary case against a person is commenced by the filing . . . of a petition . . . (1) by three or more entities, each of which is . . . a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute" Section 303(h)(1) established the following as a criterion for relief: "[T]he court shall order relief against the debtor . . . only if—(1) the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute"

99. 130 CONG. REC. S7618 (daily ed. June 19, 1984) (statement of Sen. Baucus).

100. See *supra* note 50 and accompanying text.

traced to an overly solicitous regard for the protection of debtors, the remarks evince a revived concern about the potentially ruinous consequences which the initiation of an involuntary proceeding can have on a debtor's business.¹⁰¹ Third, these comments insinuate a demonstrable pattern of heavy-handed debt collection practices accomplished through manipulation of the involuntary bankruptcy remedy. Finally, assuming Senator Baucus' statement accurately reflected legislative sentiment, Congress apparently believed that this amendment was also necessary to end the confusion over disputed debts in the case law.

The validity of these postulates about involuntary bankruptcy may be open to serious question.¹⁰² However, in appraising the wisdom of the 1984 Act modifications to the statute, and in evaluating how effectively the incorporation of this additional statutory language redressed the problems that purportedly spawned its adoption, it is instructive to first consider how the disputed debts issue has been approached by the courts subsequent to the adoption of the 1984 Act.

V. THE POST-1984 CASE LAW

A. *The Early Approaches*

The first reported decision relating to the bona fide dispute issue decided under the amended version of section 303 was *In re Johnston Hawks, Ltd.*¹⁰³ The case came before the court on the debtor's motion to dismiss based upon the assertion of defenses to each of the petitioning creditors' claims. The debtor argued that the defenses destroyed the creditors' standing under newly-amended section 303(b). In order to rule on the motion, the court initially faced the daunting task of deciding, under the scant legislative history to the 1984 amendments, the appropriate standard for determining whether the defenses rendered the petitioners' claims the subject of a bona fide dispute. Noting the paucity of prior decisions discussing disputed debts in relation to the issue of creditor standing,¹⁰⁴ the bankruptcy judge in

101. Of course, that concern, which had accounted for the severe restrictions on involuntary filings under the Act, was not totally ignored in the original drafting of the Code. See BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 189 ("The net effect of the relevant provisions of the present Act is that the business of a debtor grinds to a halt upon the filing of an involuntary petition."). Therefore, to ameliorate the disruptive impact which an involuntary filing may have, even when the order for relief is subsequently denied, the 1978 Code allowed for the debtor, in most instances, to continue to operate its business free of regulation or restriction unless and until the order for relief was entered. See 11 U.S.C. §§ 303(f), 549(b) (1982).

102. See *infra* notes 155-74 and accompanying text.

103. 49 Bankr. 823 (Bankr. D. Haw. 1985).

104. *Id.* at 830 ("Because holders of disputed claims were clearly permitted to be petitioning creditors under the Code, cases generally have not discussed disputed claims within the context of the standing of petitioning creditors."); see also discussion at *supra* notes 46-51 and accompanying text.

Johnston Hawks took an interesting approach. The court looked to and then essentially borrowed the analysis from the pre-1984 case law dealing with the question of inclusion of disputed debts under the section 303(h)(1) "generally not paying" computation.¹⁰⁵ In so doing, the court made a significant unarticulated assumption about the nature of involuntary bankruptcy law after the 1984 amendments—an assumption which, unfortunately,¹⁰⁶ also turned out to be prophetic. The *Johnston Hawks* court assumed that the standard for analyzing the bona fides of a disputed claim or debt was the same regardless of whether the issue was being decided to determine standing under section 303(b), or to evaluate the merits of the petition under section 303(h)(1).

Having decided to give credit to the balancing approaches which marked the earlier case law under section 303(h)(1), the court fashioned a test for analyzing the legitimacy of the petitioning creditors' claims under the new "bona fide dispute" language in section 303(b). The test required consideration of the following four factors:

- 1) the nature of the dispute;
- 2) the nature and the extent of the evidence supporting both the creditor's claim and the debtor's defenses;
- 3) whether the claim and corresponding defenses are asserted in good faith and without fraud and deceit; and
- 4) whether, on balance, the interests of the creditor outweigh those of the debtor.¹⁰⁷

Applying these newly-fashioned guidelines to the facts of the case before it, the court found that the claim of one of the petitioning creditors was, in fact, subject to a bona fide dispute. Therefore, the court held that the petition was defective for want of a requisite number of qualified petitioning creditors.¹⁰⁸ However, rather than immediately dismissing the petition, the court stayed its order for two weeks to allow the remaining two creditors

105. *Id.* at 830. The pre-1984 analysis of the disputed debts issue in the context of the "generally not paying" test under § 303(h)(1) is discussed at *supra* text accompanying notes 75-98.

106. *See infra* notes 176-81 and accompanying text for discussion of the reasons why a uniform standard for defining a bona fide dispute under amended § 303 may not be justified.

107. *Johnston Hawks*, 49 Bankr. at 831. Note that the fourth factor is nearly identical to the test adopted in *Semel v. Dill (In re Dill)*, 731 F.2d 629, 632 (9th Cir. 1984), for measuring when disputed debts should be included in the determination of whether or not the debtor was generally paying its debts as they became due. *See supra* note 94.

108. *Johnston Hawks*, 49 Bankr. at 832-34. The nature of the dispute between the debtor and the defeated creditor, Chicago Credit, related to whether the conditions to liability under a promissory note from the debtor to Chicago Credit's assignor, which note formed the basis of Chicago Credit's claim, had occurred. The court expressed reservation as to whether or not either party was acting in good faith, but found that, on balance, the debtor's interests in avoiding the negative consequences of an involuntary bankruptcy outweighed the counter interests of Chicago Credit. *Id.* at 832.

time to obtain the joinder of an additional creditor needed to satisfy the requirements of section 303(b).¹⁰⁹

The next case to discuss the bona fide dispute issue, *In re Stroop*,¹¹⁰ took a very different approach than the one advanced in *Johnston Hawks*. This case also involved a challenge to the petitioner's standing to seek relief under section 303(b). However, here the court concluded that the appropriate standard for determining if a claim is subject to a bona fide dispute should be the same legal test applied to summary judgment motions in conventional civil cases.¹¹¹ Under this analysis, if the debtor's defense raises material issues of fact or law sufficient to bar entry of summary judgment on the creditor's claim, then the claim will be considered subject to a bona fide dispute.¹¹² Given the extraordinary nature of summary relief, this standard represented a dramatic departure from the pre-amendment practice of defeating a petitioning creditor's standing only upon a showing of clear and indisputable invalidity of its claim.¹¹³ Not surprisingly, the creditor in *Stroop* was unable to meet this demanding standard and the petition was dismissed.¹¹⁴

Many of the cases decided since *Johnston Hawks* and *Stroop* have employed one test or the other,¹¹⁵ or adopted an approach which amounts to a variation on the themes articulated in those two earlier decisions.¹¹⁶

109. This procedure is specifically authorized by the Code. See generally 11 U.S.C. § 303(c) (1982); FED. R. BANKR. P. 1003(b) (as applied in *In re Braten*, 74 Bankr. 1021 (Bankr. S.D.N.Y. 1987)).

110. 51 Bankr. 210 (Bankr. D. Colo. 1985).

111. See FED. R. CRV. P. 56.

112. *Stroop*, 51 Bankr. at 212.

113. For the most part, in construing the pre-1984 version of § 303(b), the courts had generally accepted the proposition that the existence of the debtor's defenses were collateral to the issues raised by the petition. See, e.g., *In re All Media Properties, Inc.*, 5 Bankr. 126, 134 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981).

114. In response to the petitioning creditor's claim, which was based upon liability under a guarantee agreement, the debtor asserted reliance on alleged representations by the creditor which, if proven, might form the basis for an estoppel defense. *Stroop*, 51 Bankr. at 212.

115. See, e.g., *In re BDW Assocs.*, 75 Bankr. 909, 913 (Bankr. W.D. Pa. 1987) (employing both the "balancing test" of *Johnston Hawks* and the "summary judgment" test of *Stroop* in concluding that the petitioning creditors' claims were not subject to a bona fide dispute and that such creditors were entitled to relief based upon the debtor's failure to pay current debts), *aff'd*, B.D.W. Assocs. v. Busy Beaver Bldg. Centers, 865 F.2d 65 (3d Cir. 1989); *In re Cates*, 62 Bankr. 179 (Bankr. S.D. Tex. 1986) (adopting the *Stroop* standard); see also *In re Caucus Distribs.*, 83 Bankr. 921, 928-29 (Bankr. E.D. Va. 1988) (court discussed, without specifically adopting or rejecting any particular standard, all of the different approaches used by the courts to define a bona fide dispute for purposes of § 303).

116. For example, in *In re Hope Communications, Inc.*, 59 Bankr. 939 (Bankr. W.D. La. 1986), the court suggested that the "best approach" for identifying a bona fide dispute is one which "is a combination of these two schemes combining an analysis of competing policy interest in bankruptcy with a motion for summary judgment analysis . . ." *Id.* at 943. By contrast, in *In re Sjostedt*, 57 Bankr. 117 (Bankr. M.D. Fla. 1986), Judge Paskay simply reviewed the merits of the debtor's contrary contentions and made findings regarding whether

However, at least two bankruptcy courts expressed dissatisfaction with both the *Johnston Hawks* and *Stroop* tests. Their alternate solutions to the problem were very different.

B. The Lough and Busick Test

In *In re Lough*,¹¹⁷ the Bankruptcy Court for the Eastern District of Michigan observed that the kind of judicial balancing of the creditors' and debtor's interests proposed by *Johnston Hawks* as part of the bona fide dispute analysis, was no longer permissible in light of the 1984 amendments to section 303.¹¹⁸ Correspondingly, the *Lough* court criticized *Stroop* for not considering situations where there is no genuine issue over material facts but a genuine dispute over the legal standards applicable to those facts.¹¹⁹ To overcome this shortcoming, the court in *Lough* adopted a modified *Stroop* summary judgment test. Under this test, a creditor is disqualified when "there is either a genuine issue of material fact that bears upon the debtor's liability or a meritorious contention as to the application of law to undisputed facts."¹²⁰ Thus, in a case involving undisputed facts, the bankruptcy court would not be placed in the position of actually resolving the state law issue of the debtor's liability to the creditor.

Lough, which like *Stroop* was a single petitioner case, dealt with the bona fide dispute issue in the context of defenses to the petitioning creditor's

or not a bona fide dispute existed without specifically identifying any general rules or guidelines by which such determinations were to be governed. *Id.* at 119-20. Finally, in *Petrallex Stainless, Ltd. v. Bishop Tube Div. of Christiana Metals (In re Petrallex)*, 78 Bankr. 738 (Bankr. E.D. Pa. 1987), the court side-stepped the issue altogether, holding the new statutory exclusion for disputed debts in § 303(b) was not so broad as to include debts which should be, but which had not yet actually been, disputed. *Id.* at 744.

The standard articulated in *In re Lough*, 57 Bankr. 993 (Bankr. E.D. Mich. 1986), which probably reflects the most widely adopted test for defining a bona fide dispute for § 303 purposes, was adapted from, and in substance is simply an extension of, the *Stroop* formulation. See generally *infra* notes 117-20 and accompanying text.

117. 57 Bankr. at 993.

118. *Id.* at 995-97. The court also criticized *Johnston Hawks* to the extent it endorsed inquiry into the subjective intentions of the parties since, in the court's judgment, to do so would potentially disqualify a creditor in circumstances when the debtor asserted in good faith a claim with little or no objective merit. *Id.* at 996-97.

119. *Id.* at 997.

120. *Id.* (emphasis added). The court went on to stress that the determination of the existence of a bona fide dispute is itself sufficient to defeat the petitioning creditor's standing such that the court "must not resolve any genuine issues of fact or law." *Id.* Thus, under *Lough*, it would be even easier for the debtor to defend against a petition on jurisdictional grounds since, as to questions of pure law, the bankruptcy court would not be permitted to determine whether or not the debtor's defense was a meritorious one. Not surprisingly, on the facts of the actual case, the petitioning creditor was not able to sustain the extraordinary showing required by the court and the involuntary petition was dismissed. The fact that a claim may be deemed subject to a bona fide dispute because of a meritorious contention as to the application of law to undisputed facts does not, however, render the claim "contingent" under § 303(b). *In re Nargassans*, 103 Bankr. 446, 454 (Bankr. S.D.N.Y. 1989).

claim raised by the debtor for purposes of challenging the creditors' standing under section 303(b). However, in *In re Busick*,¹²¹ the District Court for the Northern District of Indiana adopted *Lough* as setting forth the proper legal standard for analyzing the issue of a "bona fide dispute" under both sections 303(b) and 303(h)(1).¹²² The court did not discuss or attempt to justify its use of the same test for sections 303(b) and 303(h)(1). On appeal, the Seventh Circuit affirmed,¹²³ indicating its agreement with the district court "that the standard employed by the court in *Lough* is the formulation most compatible with the congressional intent."¹²⁴ All other appellate courts that have taken a position on the question of what constitutes a bona fide dispute have elected to follow the Seventh Circuit's lead by also applying the *Lough/Busick* summary judgment "plus" test in all cases.¹²⁵

C. The Drexler and Ross Test

The other line of cases rejecting both *Johnston Hawks* and *Stroop* originated in the Bankruptcy Court for the Southern District of New York with Judge Abram's opinion in *In re Drexler*.¹²⁶ In that decision, the court

121. 65 Bankr. 630 (Bankr. N.D. Ind. 1986), *aff'd*, 831 F.2d 745 (7th Cir. 1987).

122. *Id.* at 637 ("Therefore, the court adopts the standard set forth in *Lough*: a bona fide dispute as that term is used in §§ 303(b) and 303(h)[(1)] refers to a genuine issue of material fact that bears upon the debtor's liability, or a meritorious contention as to the application of law to undisputed facts.").

123. 831 F.2d 745 (7th Cir. 1987).

124. *Id.* at 749-50. In identifying the congressional intent, the court specifically relied on the comments of Senator Baucus. See *supra* note 99 and accompanying text. The court went on to explain that, under this standard, "the bankruptcy court must determine whether there is an objective basis for either a factual or a legal dispute as to the validity of debt." *Id.* at 750. Although the court purported to be endorsing the *Lough* standard, it might be argued that this formulation represents an unwarranted expansion of the actual *Lough* test which, as a foundational matter, accepted the *Stroop* notion that if the debtor's defenses were sufficient to bar summary judgment on the creditor's claim, the claim should be treated as subject to a bona fide dispute. See *Lough*, 57 Bankr. at 996. Under Rule 56 of the Federal Rules of Civil Procedure, a court is granted very limited discretion to consider the objective merits of the disputed facts before having to deny summary judgment so that the actual evidence can be weighed at trial. See generally 10A C. WRIGHT, A. MILLER & M. KANE, FEDERAL PRACTICE AND PROCEDURE § 2728 (1983 & Supp. 1988).

125. See *B.D.W. Assocs.*, 865 F.2d at 65; *Bartmann v. Maverick Tube Corp.*, 853 F.2d 1540 (10th Cir. 1988) (which, arguably, overrules *Stroop*, even in the district (Colorado) in which it was decided). But see *infra* notes 193, 197 for discussion of whether the actual application of the stated standard by these courts was, in fact, consistent with *Lough*. Other courts adopting the *Lough* standard include: *In re Leach*, 92 Bankr. 483 (Bankr. D. Kan. 1988); *In re General Trading*, 87 Bankr. 216 (Bankr. S.D. Fla. 1988); *In re Ramm Indus.*, 83 Bankr. 815 (Bankr. M.D. Fla. 1988); *In re Garland Coal & Mining Co.*, 67 Bankr. 514 (Bankr. W.D. Ark. 1986). See *Nargassans*, 103 Bankr. at 449-50, in which the court, without expressly adopting this standard, seemed to apply its reasoning in determining that certain of the petitioners' claims were the subject of a bona fide dispute.

126. 56 Bankr. 960 (Bankr. S.D.N.Y. 1986). For a related decision involving an affiliated debtor, see *In re Drexler Assocs.*, 57 Bankr. 312 (Bankr. S.D.N.Y. 1986).

spurned the *Johnston Hawks* balancing test as involving an unwarranted inquiry into the debtor's subjective good faith in contradicting the petitioning creditor's claim.¹²⁷ Judge Abram also rejected the *Stroop* summary judgment test as ill-conceived at least in those situations when the dispute is the subject of state court litigation which is already in the advanced stages by the time the involuntary petition is filed.¹²⁸

However, after summarily dismissing the two existing formulations for defining a bona fide dispute, the court demurred at attempting to devise yet another all-embracing set of guidelines. Instead, Judge Abram elected to decide the case on its particular facts and limit its precedential value accordingly.¹²⁹ Specifically, the court cited a reluctance to set or attempt to define the "outer boundaries" of the newly-included bona fide dispute language of section 303, preferring instead to await the further refinement which, Judge Abram concluded, would surely be supplied over time in the form of subsequent adversary adjudications and scholarly commentary.¹³⁰

As to the two fact patterns actually presented in the case, *Drexler* did offer certain generalized answers for the benefit of future litigants. First, the court held that a creditor's claim based on an unstayed final judgment could not be subject to a bona fide dispute for involuntary bankruptcy purposes notwithstanding a pending appeal by the debtor¹³¹ or even post-

127. *Drexler*, 56 Bankr. at 966-67. Although decided before *Lough*, it is clear that the court had the same basic criticisms of *Johnston Hawks* as did the *Lough* court. See *supra* note 118 and accompanying text. In addition, the court in *Drexler* found that the *Johnston Hawks* standard was inappropriate in light of the advanced stage of the state court litigation at the time the petition was filed, to which, the bankruptcy court believed, more deference should be afforded. Specifically, the claims had already been reduced to final judgment, although an appeal was pending as of the date the petition was filed. *Drexler*, 56 Bankr. at 966-67.

128. *Drexler*, 56 Bankr. at 966.

129. *Id.* at 967. Note that this approach is similar to the one adopted by the Second Circuit prior to the 1984 amendments in deciding to await more cases before deciding whether to accept, reject or modify the *Covey* test for analyzing dispute debts under § 303(h)(1). See *B.D. Int'l Discount Corp. v. Chase Manhattan Bank (In re B.D. Int'l Discount Corp.)*, 701 F.2d 1071, 1077 (2d Cir.), *cert. denied*, 464 U.S. 830 (1983).

It may be significant, however, that in a later case Judge Abram cited *Lough* (which had been decided in the interim), with seeming approval in dismissing an involuntary petition on the basis of a "bona fide question" about the debtor's liability to the petitioners. See *In re Equidyne Properties*, 60 Bankr. 245, 249 (Bankr. S.D.N.Y. 1986); see also *In re Tikijian*, 76 Bankr. 304, 314-15 (Bankr. S.D.N.Y. 1987), wherein Judge Abram also cited *Lough* as in accord with her views concerning the inappropriateness, in some cases, of the *Stroop* and *Johnston Hawks* tests; cf. *infra* notes 136, 138 and accompanying text for further consideration of the relationship between the *Lough* standard and *Drexler*.

130. *Drexler*, 56 Bankr. at 967.

131. *Id.* at 967-68; accord *Caucus Distribs.*, 83 Bankr. at 928; *In re Schiliro*, 64 Bankr. 422, 425 (Bankr. E.D. Pa. 1986); see also *In re Albers*, 71 Bankr. 39 (Bankr. N.D. Ohio 1987) (debtor's contention that a creditor's judgment was fraudulently procured did not preclude creditor from asserting the non-satisfaction of such judgment as a basis for involuntary relief). The *Drexler* court did, however, allow that had the judgment been stayed pending appeal, the creditor would likely be barred from joining in the involuntary petition. *Drexler*, 56 Bankr. at 967 n.11; see also *In re Raymark Indus.*, 99 Bankr. 298 (Bankr. E.D. Pa. 1989).

filing developments on appeal favorable to the debtor.¹³² Second, the *Drexler* court ruled that the debtor's assertion of counterclaims, "even if of substance, does not render the petitioner's claim the subject of a bona fide dispute."¹³³ However, the court noted that it was still necessary to consider the substance of the counterclaims since, if clearly established, they might operate to work a diminution or setoff of the petitioners' claims, "either as part of the Code § 303(b)(1) analysis of the amount of the petitioner's claim or as part of the Code § 303(h)(1) analysis of generally not paying, in which the amount of a petitioner's claim may be relevant."¹³⁴ After considering the facts before it, the court determined that the debtor's counterclaims were without value. The court reached this result because the issues raised by some of the counterclaims had already been finally adjudicated in the creditors' favor in state court, and the other counterclaims could not be evaluated without unduly delaying a decision on the petition.¹³⁵

The *Drexler* court's treatment of unadjudicated counterclaims could be seen as a rejection of the *Lough* approach. Under *Lough*, the mere existence of potentially meritorious defenses are alone enough to bar the creditor's claim. On the other hand, the *Drexler* departure from the *Lough* formulation may be explained, or at least limited, by the court's distinction between defenses and counterclaims,¹³⁶ a situation that was simply not presented in *Lough*. Moreover, both courts agreed that the role of the bankruptcy courts in passing on an involuntary petition is not actually to decide the underlying merits of disputed claims.¹³⁷

132. Subsequent to the filing of the involuntary case, an appeal of one of the petitioners' two pre-filing judgments was remanded by the Second Circuit on the basis that the district court's certification of finality under Federal Rule of Civil Procedure 54(b) was improper. However, Judge Abram observed that in determining matters respecting the petitioners' claims, the bankruptcy court was obliged to consider the situation as it stood on the date the petition was filed, provided that subsequent developments did not render a result manifestly unjust. *Drexler*, 56 Bankr. at 968.

133. *Id.* at 969; accord *In re J.B. Lovell Corp.*, 88 Bankr. 459, 462 (Bankr. N.D. Ga. 1988).

In holding that a debtor's counterclaims do not render the petitioner's claim subject to a bona fide dispute, Judge Abram acknowledged her departure from the position espoused by another bankruptcy court in *In re Henry*, 52 Bankr. 8 (Bankr. S.D. Ohio 1987). In that earlier decision, the court had found the existence of such unresolved counterclaims sufficient to overcome the standing of two petitioning creditors holding final judgments against the debtor. *Henry*, 52 Bankr. at 10 (while the question of liability on the creditors' claims was settled by entry of final judgment, what unsettles the matter is the debtor's unadjudicated claim which can effectively eliminate the debtor's technical liability). Cf. *In re Kreidler Import Co.*, 4 Bankr. 256 (Bankr. D. Md. 1980). For a discussion of *Kreidler*, see *supra* notes 65-69 and accompanying text.

134. *Drexler*, 56 Bankr. at 969-70.

135. *Id.*

136. See *id.* at 969 n.16 (court articulated such a distinction between defenses which go to the heart of the petitioner's claim, and thus automatically create a bona fide dispute, and counterclaims).

137. See *supra* note 120 and accompanying text.

Like most other post-1984 decisions, *Drexler* drew no distinction between the definition of a "bona fide dispute" under sections 303(b) and 303(h)(1).¹³⁸ However, the *Drexler* court suggested that, prior to entering a final ruling on the petition, it would be appropriate to balance the interests of the creditors against those of the debtor to ensure that the "preliminary" result reached by the court on the bona fide dispute question was compatible with the "broader policy considerations evidenced in the sparse legislative history to the [1984] amendment."¹³⁹ In the instant case the debtor's business enterprise had been in a "downward spiral" for well over a year, a fact Judge Abram found weighed heavily in the petitioners' favor. Thus, the court concluded that the equities supported the initial result it had reached through its formal analysis under section 303(h)(1).¹⁴⁰

Judge Abram had occasion to more fully develop her approach to defining a bona fide dispute under section 303 in *In Re Ross*,¹⁴¹ a case decided within a year of *Drexler*. In *Ross*, the debtor asserted counterclaims and defenses against the claims of several petitioning creditors for purposes of contesting jurisdiction under section 303(b) and opposing the petitioners' entitlement to relief under section 303(h)(1).¹⁴² Citing *Drexler*, Judge Abram noted that her first responsibility in deciding whether the debtor's legal position had merit was to review the posture of any pre-petition litigation and give full effect to rulings made in that litigation as of the time the involuntary case was filed.¹⁴³ Thus, the unstayed final judgment in favor of one creditor precluded the debtor from asserting that a bona fide dispute existed concerning that creditor's claims.¹⁴⁴ As to the non-final judgments held by other creditors, the judge held that these also barred the debtor's contention of a bona fide dispute. The judge supported this extension of the *Drexler* holding by noting that these judgments were a "giant step" towards the entry of final judgments.¹⁴⁵

Ross also involved a situation well beyond the parameters of the *Drexler* holding. The claims of one petitioner were only in the most preliminary

138. *Drexler*, 56 Bankr. at 971.

139. *Id.* at 972.

140. *Id.*

141. 63 Bankr. 951 (Bankr. S.D.N.Y. 1986).

142. The factual background of the case was exceedingly complex, involving eight related voluntary and involuntary cases and what the court referred to as a "sea of litigation" both prior to and subsequent to the filing of the petition. *Id.* at 954. *Ross*, the debtor, was apparently a promoter of several real estate limited partnerships of which he or a related entity served as general partner. See generally *Equidyne Properties*, 60 Bankr. at 245.

143. *Ross*, 63 Bankr. at 960.

144. *Id.* at 969. Also, consistent with its position in *Drexler*, the court noted that the post-filing vacation of such judgments on appeal on procedural grounds did not alter the analysis since the relevant time for measuring the existence of a bona fide dispute is as of the date and time the involuntary case is commenced. *Id.* at 972.

145. *Id.* at 967.

stages of adjudication at the time the involuntary case was commenced. Therefore, the pending state court proceeding offered no guidance to the bankruptcy court in evaluating the legitimacy of the debtor's counterclaims and defenses. In this situation, Judge Abram considered it proper to apply the *Stroop* summary judgment test to these claims.¹⁴⁶ She concluded that the debtor's defenses were factually and legally insufficient to withstand a summary judgment motion by the creditor, and thus did not create a bona fide dispute under section 303.¹⁴⁷ With regard to the debtor's counterclaims, Judge Abram reaffirmed her *Drexler* holding that counterclaims alone do not create a bona fide dispute, and need not even be considered when computing the amount owed by the debtor if to do so would unduly delay disposition of the petition.¹⁴⁸

In addition to further defining the limitations of a bona fide dispute, *Ross* is noteworthy for Judge Abram's admonition that, in considering the standing of each petitioning creditor under section 303(b), "[u]ndue weight cannot be placed on the nature of the claims held by the petitioners as the debtor's true protection . . . lies in the independent requirement of Code § 303(h)"¹⁴⁹ Further, she noted that, ultimately, before ordering relief in a contested involuntary case, "the court must test its result by balancing the interests of the creditors against those of the debtor"¹⁵⁰ Later in the decision, the judge also stated: "It is conceptually possible that the claim of a person deemed an eligible petitioning creditor will ultimately be disallowed since the inability to grant summary judgment in the petitioner's favor is not necessarily fatal to the petitioner's standing."¹⁵¹ These observations were not central to the court's holdings in the case and, in fact, were offered in a somewhat offhand way in the general discussion of principles guiding the determination of each petitioning creditor's eligibility. Nevertheless, they represent the first, and arguably the only, suggestions in the post-1984 Bankruptcy Act case law that perhaps the test of a bona fide dispute under section 303(b) might be different, or at least applied differently, than the standard used to address the same question for section

146. See *supra* notes 111-12 and accompanying text.

147. *Ross*, 63 Bankr. at 962-63. Judge Abram's application of the *Stroop* test in this context should not be viewed as a wholesale endorsement. See *infra* note 150 and accompanying text. Also, in a later case from the same district, *Nargassans*, 103 Bankr. at 446, Judge Buschman described the rule in the Second Circuit as "not so strict" as the standard imposed by the *Stroop* summary judgment test. *Id.* at 449. However, in support of that proposition the judge cited pre-1984 case law—*B.D. Int'l Discount*, 701 F.2d at 1071, 1076. For discussion on *B.D. Int'l Discount*, see *supra* notes 64, 94.

148. *Ross*, 63 Bankr. at 964.

149. *Id.* at 961.

150. *Id.*; see also *In re B.B.S.I., Ltd.*, 81 Bankr. 227, 230-31 (Bankr. E.D.N.Y. 1988) (applying the balancing test proposed in *Ross* to support the conclusion that the petitioning creditors' claims were subject to a bona fide dispute).

151. *Ross*, 63 Bankr. at 964-65.

303(h)(1) purposes. Regrettably, Judge Abram failed to further embellish this notion in *Ross* and it has been largely ignored in the subsequent decisional law.¹⁵² Moreover, in a later opinion,¹⁵³ Judge Abram considered the finding of an absence of a bona fide dispute for purposes of section 303(b) conclusive with respect to whether or not those claims would be included in the "generally not paying" analysis under section 303(h)(1).¹⁵⁴ However, as I argue in the final part of this Article, such a distinction is not only rational in light of the policy objectives underlying involuntary bankruptcy, it is consistent with the legislative purpose and the actual experience which account for section 303 in both its original and present forms.

VI. ASSESSING THE IMPACT AND WISDOM OF THE 1984 AMENDMENTS TO SECTION 303

Five years later, it is worthwhile to appraise how effectively the 1984 amendments directed to section 303 have responded to the articulated concerns and objectives which prompted their adoption. Certainly, there can be no doubt that the mandatory exclusion under section 303 of claims and debts subject to a bona fide dispute has "upped the ante" for creditors considering resort to the involuntary bankruptcy remedy. Statistical information collected and maintained by the Administrative Office of the United States Courts indicates that the number of involuntary filings has dropped steadily in recent years.¹⁵⁵ This reduction in the volume of involuntary cases, which shows every sign of continuing, should come as no surprise. Under the original 1978 version of section 303, petitioning creditors in involuntary cases already pulled the laboring oar in what amounted to a demanding

152. *But see In re Elsub Corp.*, 70 Bankr. 797, 814 (Bankr. S.D.N.J. 1987), wherein the court referred to certain of the above-quoted portions of *Ross*, but only for the apparent purpose of suggesting that the *Stroop* test, at least in some contexts, may be too strict and demanding a standard for defining when a debt is subject to a bona fide dispute; *see also Tikijan*, 76 Bankr. at 315 ("In the final analysis, it must be concluded that the issues raised on a motion for summary judgment are not coextensive with the question of whether a claim is the subject of a bona fide dispute.").

153. *Tikijan*, 76 Bankr. at 304.

154. *Id.* at 321.

155. Figures from the Administrative Office indicate that for the years 1982-85 ending June 30 (commencing just prior to the effective date of the amendment to § 303), the total number of involuntary Chapter 7 and 11 cases, expressed as a percentage of total filings, were as follows: forty-two hundredths of one percent (0.42%), forty-five hundredths of one percent (0.45%), forty-two hundredths of one percent (0.42%), and forty-four hundredths of one percent (0.44%). The corresponding figures for the years 1986 (the first full year under amended § 303) through 1988 ending June 30, were as follows: twenty-eight hundredths of one percent (0.28%), twenty-nine hundredths of one percent (0.29%), and twenty-three hundredths of one percent (0.23%). *See Annual Report of the Director of the Administrative Office of the United States Courts* (1987) (available on request from the Office of Public Information).

and potentially expensive piece of litigation.¹⁵⁶ In most cases, debtors had every incentive to vigorously resist the petition. On top of that, petitioning creditors have always been subject to the risk of affirmative liability in the event that the debtor is successful in obtaining a dismissal of the petition.¹⁵⁷ On the other hand, notwithstanding the added burden and risk assumed, petitioning creditors receive no favored treatment or other special advantage in the bankruptcy administration which follows entry of an order for relief on an involuntary petition.¹⁵⁸

The 1984 amendments have now further discouraged involuntary filings. By complicating the petitioners' proof, and adding to the statutory bases upon which a debtor might controvert and defend a petition, Congress has made the prosecution of involuntary filings an even more difficult and perilous affair. While there is no question that the 1984 amendments have reduced the number of involuntary filings, that the placement of these additional obstacles in the path of involuntary relief was warranted, or that they represent a necessary or inevitable price to be paid to achieve other important policy objectives, is a far more debatable proposition.

As a starting place, it is revealing to recall the reasons which first prompted reform of the law and procedure governing involuntary bankruptcy in 1978.¹⁵⁹ It is interesting, if not ironic, to note that it was the perceived need to simplify the issues in involuntary cases, and thereby promote their prompt and effective disposition, that persuaded the drafters of the Bankruptcy Code to lower the barriers which had frustrated creditors' access to bankruptcy relief under the 1898 Act.¹⁶⁰

156. In a controverted case, the pre-trial and trial procedures governing litigation of an involuntary petition are essentially the same as those governing any federal civil action. *See* FED. R. BANKR. P. 1018 (which makes the federal discovery rules applicable in involuntary cases). *See generally* S. SNYDER & L. PONOROFF, *COMMERCIAL BANKRUPTCY LITIGATION* § 5.12 (1989) (discussion of the procedures governing the disposition of involuntary petitions).

157. *See* 11 U.S.C. § 303(i) (1982 & Supp. IV 1986). At the court's discretion, the petitioning creditors may also be required to, as a condition to going forward with their case, post a bond to indemnify the debtor for such amounts as the court may later determine are due to the debtor under § 303(i). 11 U.S.C. § 303(e) (1982).

158. After entry of an order for relief on an involuntary petition, the manner in which the case proceeds is indistinguishable from a routine voluntary case, which is to say that the claims of the petitioning creditor are treated without preference to the comparable claims of all other similarly situated non-petitioning creditors. *See* 11 U.S.C. §§ 507, 726, 1129 (1982 & Supp. IV 1986), which, in terms of priority, order of distribution, and plan confirmation requirements, make no special provision for petitioning creditors in an involuntary case. However, successful petitioning creditors may seek reimbursement for actual costs and expenses incurred in obtaining an order for relief by filing an administrative expense claim for such amounts under § 503(b)(3)(A), (b)(4).

159. *See supra* notes 36-39 and accompanying text.

160. *See, e.g., In re All Media Properties, Inc.*, 5 Bankr. 126, 133-36 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981); *BANKRUPTCY COMMISSION REPORT, supra* note 38 at 186-89.

After just a few years of experience under the Code, and without any apparent study, Congress decided to tinker with the new statutory scheme. As discussed earlier,¹⁶¹ the sponsor of the 1984 Act's amendments to section 303 cited two principal reasons for explicit inclusion of the exclusionary language concerning disputed debts: 1) misuse of the bankruptcy system as a tool of coercion; and 2) judicial misinterpretation and uncertainty over the proper treatment under section 303 of debts that were subject to good faith dispute.¹⁶² The first of these justifications could hardly be characterized as blazing virgin trails. While the potentially devastating consequences of an involuntary filing on a debtor's business make the concern over improper or malicious filings an important one, it was not a concern as to which the drafters of the 1978 version of section 303 were oblivious. However, the balance struck at the time was to discourage, control and punish such practices without, in the process, compromising the countervailing and equally salient concern over the right of creditors to compel an involuntary proceeding when bankruptcy court protection is needed. Furthermore, lest that right exist in name only, it was understood that creditors' ability to initiate a bankruptcy administration had to be freed of the prejudicial constraints resulting from requirements involving intricate and arduous issues of proof and posing the prospect for protracted litigation over the petition.¹⁶³

The drafters compensated for the 1978 Code's liberalized criteria for seeking and obtaining involuntary relief in two important ways. First, in the "gap period" between the filing of the petition and entry of an order for relief, section 303(f) has always allowed the debtor to retain control of and operate its business free of Bankruptcy Code restriction or regulation.¹⁶⁴ This autonomy granted to the debtor over the conduct of its own affairs reduces the unsettling effect which the filing of an even non-meritorious

161. 130 CONG. REC. S7618 (daily ed. June 19, 1984) (statement of Sen. Baucus); *see supra* text accompanying note 99.

162. *Id.* Specifically, Senator Baucus maintained:

I believe this amendment, although a simply [sic] one, is necessary to protect the rights of debtors and to prevent misuse of the bankruptcy system as a tool of coercion. I also believe it corrects a judicial misinterpretation of existing law and congressional intent as to the proper basis for granting involuntary relief.

Id.

163. *See* BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 188; *In re Covey*, 650 F.2d 877, 882 (7th Cir. 1981); *see also supra* note 39 and accompanying text.

164. Generally, it is not until entry of the order for relief that the constraints imposed on the use or disposition of property of the estate imposed by § 363 become applicable. 11 U.S.C. § 363 (1982 & Supp. IV 1986). However, where it appears that the debtor may conceal or abscond with assets of the estate, or dispose of them in some manner detrimental to the creditors' interests, the debtor's rights during the gap period may be restricted by the court. *See* 11 U.S.C. § 303(f) (1982); S. REP. No. 989, 95th Cong., 2d Sess. 33, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5819; H.R. REP. No. 598, 95th Cong., 2d Sess. 323, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6279. This represents a significant change from operation of involuntary bankruptcy under the Act. *See* § 70a of the Act which vests all title to the debtor's property in the trustee as of the date of filing.

petition might otherwise have on the orderly operation of the debtor's business. In addition, the Code provides substantial protection for creditors who continue to deal with the debtor during the gap period.¹⁶⁵ This overall attempt to preserve the status quo pending a disposition on the petition was a clear departure from practice under the former Bankruptcy Act, and was purposefully designed to protect debtors from ill-conceived and spitefully motivated petitions.¹⁶⁶

The second, and arguably more important, reform which was incorporated into the original drafting of section 303 has already been mentioned. It involved the conferral of substantial discretion on bankruptcy judges to award the debtor fees and costs upon the dismissal of an involuntary petition other than on the consent of all of the parties.¹⁶⁷ Furthermore, if the debtor can establish that the petition was filed in bad faith, the court has always had the authority under the Code to award compensatory and punitive damages to the debtor for harm caused by the filing.¹⁶⁸

The protections contained in section 303(i), also without direct counterpart under the Act, were intended to deter creditor abuse of the involuntary bankruptcy process which might otherwise have resulted from the Code's elimination of the requirement that the petitioning creditors plead and prove the commission of one of the specific "acts of bankruptcy."¹⁶⁹ In identifying what criteria might support a finding of bad faith, the courts have uniformly held that the filing of an involuntary petition solely as a substitute for the routine collection remedies and devices provided by state law is actionable.¹⁷⁰ Therefore, the concern about the "unintended inequity in the law of

165. 11 U.S.C. § 549(b) (1982 & Supp. IV 1986) operates to shield from the trustee's avoiding powers post-petition transfers of the debtor's property to creditors who extend new value in the gap period. Further, if a gap period creditor's claim arising in the ordinary course is not repaid before the order for relief is entered, that claim is entitled to priority in distribution over other general creditors' claims in the ensuing bankruptcy administration. 11 U.S.C. §§ 507(a)(2), 502(f) (1982 & Supp. IV 1986).

166. See BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 189-90 (discussing the lack of protection for gap creditors under the former Bankruptcy Act). Compare § 70d of the former Act (restricting protection of post-filing transferees to those without knowledge or who had reasonable cause for believing that the petition was unfounded) with § 549(b) of the Code (protecting all post-petition transferees that take for value).

167. 11 U.S.C. § 303(i)(1) (1982), amended by Pub. L. No. 99-554, § 204(1) (now codified in 11 U.S.C. § 303(i)(1) (Supp. IV 1986) (eliminating § 303(i)(1)(c))). Costs and attorneys' fees may be awarded under § 303(i)(1) regardless of whether the petition is found to have been filed without just cause or in bad faith. See, e.g., *In re Leach*, 102 Bankr. 805, 808 (Bankr. D. Kan. 1989).

168. 11 U.S.C. § 303(i)(2) (1982). Petitioning creditors' potential liability upon the dismissal of an involuntary petition is discussed in S. SNYDER & L. PONOROFF, *supra* note 156, § 5.14.

169. See *All Media*, 5 Bankr. at 135 (provisions of § 303(i) "are new, did not appear in the Bankruptcy Act, and should be sufficient to deter those who would bring frivolous petitions against the debtors." (citing BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 190)).

170. See, e.g., *In re F.R.P. Indus.*, 73 Bankr. 309, 313 (Bankr. N.D. Fla. 1987); *In re Johnston Hawks, Ltd.*, 72 Bankr. 361, 367 (Bankr. D. Haw. 1987); *In re SBA Factors of Miami*, 13 Bankr. 99, 101 (Bankr. S.D. Fla. 1981).

involuntary bankruptcies," which was offered as one of the principal justifications for the 1984 amendments to section 303,¹⁷¹ had already been addressed by the existing language of the Code and by the courts' willingness to construe that language broadly in protecting the integrity of their own jurisdiction.

Moreover, there is no reason to believe that the concern over the potential for misuse of the bankruptcy system to coerce payment of validly disputed debts had been addressed in a less than adequate or satisfactory manner. Nowhere in the legislative history of the 1984 Act is there (nor was there in the literature up to that time) any evidence that the reforms in 1978 which had encouraged the earlier initiation of involuntary cases had also spawned a rash of either careless or abusive filings. In fact, the original version of section 303 appeared to fairly balance the somewhat contradictory goals of creating a more effective and equitable system of creditor relief without unduly exposing business debtors to an excessive risk of creditor misbehavior. In short, when considered in light of the actual circumstances which existed at the time, the facially acceptable explanation of the 1984 amendments to section 303 as necessary to "protect the rights of debtors,"¹⁷² begins to lose its convincing and appealing ring.

Similarly, the 1984 amendments to section 303 have not meaningfully, or even perceptibly, alleviated the interpretational problems, uncertainty, and judicial disagreement surrounding the treatment of disputed debts under section 303. Rather, the new statutory language has operated simply to recast the manner in which the issue arises and is debated. Instead of addressing the disputed debts question in the guise of whether the debtor's counterclaims and defenses should be recognized at all, the courts are now faced with the even more vexing task of finding the proper standards for identifying the presence or absence of a so-called bona fide dispute. Moreover, the inquiry into a proper definition of a debt subject to a bona fide dispute may be nothing more than a thinly disguised way of addressing the original question of how much significance should be attached to the assertion of alleged defenses or counterclaims to particular creditor claims.¹⁷³

171. 130 CONG. REC. S7618 (daily ed. June 19, 1984) (statement of Sen. Baucus); *see supra* text accompanying note 99; *see also In re Stroop*, 47 Bankr. 986, 988 (Bankr. D. Colo. 1985) (suggesting that the accelerated effectiveness of the 1984 Act's provisions amending § 303 might be explained as necessary to protect debtors in pending cases from "inequitable treatment").

172. *See supra* text accompanying note 99.

173. The fact that many of the decisions addressing this issue may be explainable only in terms of result-oriented reasoning does not mean that the change in the underlying legal doctrine has had no impact on the outcome of particular cases. Clearly, cases which would have been resolved favorably to the petitioning creditors prior to the effective date of the amendments to § 303 have gone the other way. For example, it would be impossible to dispute that the Seventh Circuit's shift in position concerning the treatment of disputed debts under

If the net impact of the amendments to section 303 was simply that they failed to provide greater certainty in the law or to offer more protection for debtors, one might have concluded that no real harm was done. But there has been a cost. It comes in the form of added reason for creditors to hesitate to seek bankruptcy relief before the debtor becomes hopelessly insolvent, and while preferential and other voidable transfers may still be recovered. Such excessive restraint frustrates core bankruptcy policy of maximizing value through orderly and equitable debt collection procedures. An equally damaging by-product of the amendments is the courts' abandonment of the sensible distinction which previously prevailed in relation to the disputed debts question. For the most part,¹⁷⁴ the post-1984 cases no longer exhibit any concern over the purpose for which the inquiry regarding the validity of claims is being raised.

For all of these reasons, I will argue in the material that follows that the bankruptcy courts should consider articulating and applying a more content-neutral approach for determining when a debtor's alleged dispute to a claim rises to the level of a "bona fide" dispute. Additionally, I will contend that this determination should be made in a manner which is responsive to the policies and purposes of involuntary bankruptcy and tempered by an appreciation for the context under section 303 in which the issue arises. Finally, although I chart a different course from those followed by the majority of courts to date, I will show that my proposals do not ignore or contradict either the express commands of the amended statute or the legislative explanation for the amendments.

§ 303(h)(1) from *Covey* to *Busick* has had and will continue to have an impact. The point, however, is that, in the close case, it is not surprising to see a court deviate from the articulated standards in order to accomplish a just result. Judge Abram's adoption of a case-by-case approach for developing a definition of the phrase "bona fide dispute" in varying factual situations reflects perhaps the most honest admission of this fact. See *In re Drexler*, 56 Bankr. 960, 967 (Bankr. S.D.N.Y. 1986); *supra* note 130 and accompanying text.

As an additional illustration, it is instructive to compare the similarity in the nature of the claims and defenses in *In re Lough*, 57 Bankr. 993 (Bankr. E.D. Mich. 1986), and *In re Tikijian*, 76 Bankr. 304 (Bankr. S.D.N.Y. 1987). In each case the debtor raised factual allegations concerning oral understandings affecting the nature and scope of the debtor's asserted liability under written guaranty agreements. In *Lough*, applying its expanded summary judgment test, the court considered such allegations sufficient to render the debtor's liability subject to a bona fide dispute. *Lough*, 57 Bankr. at 997-98. By contrast, the court in *Tikijian*, applying a very similar standard, reached just the opposite result. *Tikijian*, 76 Bankr. at 315-20. While it is of course possible to justify, as the courts in fact did, the results in each case by reference to the apparent objective merits of the defenses, which were obviously more compelling in *Lough* than *Tikijian*, it is equally plausible to suggest that, perhaps, the differing outcomes are best explained based on the seemingly transparent and self-serving nature of the debtor's contentions in *Tikijian* as compared with *Lough*. In any event, while these cases may be distinguished from one another on the facts, overall it is hard to see how doctrinally the amendments have added much in terms of interpretational certainty or clarity.

174. The *Ross* court's acknowledgement that, in the final analysis, the debtor's real protection is found in § 303(h), is one of the few exceptions to this statement. *In re Ross*, 63 Bankr. 951, 961 (Bankr. S.D.N.Y. 1986). See *supra* notes 141-54 and accompanying text.

VII. EXISTENCE OF A BONA FIDE DISPUTE: AN ALTERNATIVE FRAMEWORK FOR ANALYSIS

Under the 1978 version of section 303, the courts generally agreed that it made a difference why the bona fide dispute issue was raised. Unquestionably, that appreciation has been abandoned since the amendment of the statute in 1984. Given the legislative history to amended section 303, it is perhaps understandable that the courts have routinely applied the same standard in defining a bona fide dispute for purposes of both sections 303(b) and 303(h)(1). However, that legislative history consists of only a single statement on the Senate floor by the sponsor of the amendment; a statement which not only presumes a set of existing problems that are unsubstantiated by any empirical evidence, but which, in fact, may be at odds with the actual experience under section 303 as originally drafted.¹⁷⁵ Thus, to understand why the courts have reacted to the amendments in this way is one thing; to applaud the practice is quite another.

Even prior to the amendments, the courts had never been oblivious to the problem created by an involuntary debtor's good faith dispute to a creditor claim. In fact, particularly insofar as entitlement to relief was concerned, the courts had largely accepted the notion that legitimately disputed debts should be excluded from the "generally not paying" analysis.¹⁷⁶ The only really uncertain matter was then, as it is no less now, how to define and identify a bona fide dispute. Prior to 1984, courts interpreting section 303 were hesitant, except in the most clear-cut case, to exclude disputed claims from the ambit of "claims" qualified under section 303(b). However, there were both logical and justifiable reasons for this distinction. First, the Code might be read as attaching to the term "claim" under section 303(b) a broader meaning than the term "debt" as used in section

175. See 130 CONG. REC. S7618 (daily ed. June 19, 1984) (statement of Sen. Baucus); see also *supra* text accompanying note 99. Although Senator Baucus never indicated in his comments that a uniform standard should necessarily be used in identifying a bona fide dispute for all purposes under § 303, neither did he specify a contrary interpretation. Thus, the courts, in formulating proper tests of a bona fide dispute, reacted predictably to the fact that the amendments to §§ 303(b), 303(h)(1) were promulgated as part of the same provision of the 1984 Act, see *supra* note 10 and accompanying text, and are similar in content. In so doing, they lost sight of the underlying consequences flowing from the determination; a recognition which had largely guided the analysis under the Reform Act prior to the 1984 Act.

176. See, e.g., *In re Covey*, 650 F.2d 877, 882-84 (7th Cir. 1981). The court, in describing the current state of the law regarding disputed debts, stated: "creditors holding disputed claims are not . . . disqualified from petitioning for involuntary bankruptcy," but "a dispute can affect whether nonpayment of a debt should be counted in determining whether a debtor is generally paying debts as those debts become due." *Id.* at 878; see also *In re Stroop*, 51 Bankr. 210, 211 (Bankr. D. Colo. 1985) (prior to the 1984 Act, the courts generally concurred that the existence of a bona fide dispute would not bar the creditor from placing the debtor in an involuntary proceeding).

303(h)(1).¹⁷⁷ Second, and more importantly, the legislative history of original section 303(b) reveals a clear intent to achieve a fairer distribution of limited assets by relaxing the standing and proof requirements for involuntary cases under the Bankruptcy Code.¹⁷⁸ In so doing, Congress sought to redress the imbalance perceived to have existed under prior law by expanding creditor access to bankruptcy relief.¹⁷⁹

In light of this background, Senator Baucus' comments explaining the justifications for amendment of section 303 are suspect. They ignore not only what had earlier been identified as the foundational ill to be eradicated in reforming the law of involuntary bankruptcy, but also the range and varying content of the diverse judicial attitudes toward section 303 prevailing at the time. Correspondingly, by lumping together the analysis of the bona fide dispute issue in two very different contexts, the 1984 Act amendments have precipitated a harmful judicial overreaction to what, at most, amounted to a few aberrant cases and an alleged but unsubstantiated pattern of creditor "misuse" of the bankruptcy system. The subsequent reduction in the percentage of filings under amended section 303,¹⁸⁰ a phenomenon very likely attributable to the more inflexible judicial posture toward involuntary bankruptcies bred by the new statutory language, loudly signals a return to the pre-1978 days of "creditor dissatisfaction and lack of interest" in the bankruptcy system.¹⁸¹ By interpreting the statute in a manner which vastly complicates creditors' difficulties of proof and, therefore, increases the costs and risks associated with seeking bankruptcy relief, courts have largely

177. Courts have read "claim" and "debt" differently in other contexts. For example, in *In re Lambert*, 43 Bankr. 913, 918 (Bankr. D. Utah 1984), the court held that, in applying the debt limitations in § 109(e) governing eligibility to Chapter 13 relief, the term "claim" has a broader meaning than "debt." *Id.* Thus, the argument can be made that, by definition, a "claim" includes a disputed obligation, 11 U.S.C. § 101(4) (1982), but that since a debt is defined as "liability on a claim," 11 U.S.C. § 101(11) (1982), use of the term "debt" necessarily implies a congressional intent to limit the focus of the analysis to nondisputed claims. *But see* H.R. REP. NO. 595, 95th Cong., 2d Sess. 310, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6267 (terms "claim" and "debt" are coextensive); *Energy Coop., Inc. v. SOCAP Int'l, Ltd. (In re Energy Coop., Inc.)*, 832 F.2d 997 (7th Cir. 1987); *New York Credit Adjustment Bureau v. Just In-Materials Designs (In re Vasu Fabrics)*, 39 Bankr. 513, 516 (Bankr. S.D.N.Y. 1984) ("The differences in these [two] terms are [merely] ones of point of view . . .").

178. *See generally In re North County Chrysler Plymouth*, 13 Bankr. 393, 399 (Bankr. W.D. Mo. 1981) ("By eliminating the need to have a provable, liquidated claim, the Congress has stated a policy in favor of a liberal taking of jurisdiction in involuntary cases.").

179. *Id.* at 396 ("The history of the language of § 303(b)(1) reflects a gradual easing of the requirements imposed upon the petitioning creditor."); *see also supra* note 36 for citation of authority criticizing practice under the former Bankruptcy Act; *cf.* BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 188 ("Under the present Act, it is easy for a creditor to initiate an involuntary proceeding.").

180. *See supra* note 155 for an actual statistical breakdown relative to the number of involuntary filings as a percentage of total filings both before and after the 1984 Act.

181. *See* BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 187-88.

neutralized any benefits that creditors might have otherwise gained by resort to the involuntary bankruptcy remedy.

It is submitted that such a result is wrong and that the 1984 amendments to section 303 should be interpreted and applied with attention to the prior history and experience of involuntary bankruptcy under the Act and the early Code. While this might necessarily entail discounting to some degree the significance of the only extant expression of legislative intent, there are no formal committee reports explaining the language of amended section 303 and, as a matter of statutory construction, individual floor statements are generally regarded as far less definitive expressions of congressional intent than committee reports.¹⁸² Moreover, when equity and common sense demand, the judiciary is not bound to honor exogenous statements of purpose and intent when construing specific legislative enactments.¹⁸³

Prior to the 1984 Act, courts generally recognized the existence of jurisdiction over petitions filed by creditors holding disputed claims, but then took the existence of such disputes into account in ruling on the merits of the petition.¹⁸⁴ This system, as even the sponsor of the amendment admitted, had "proved to be both workable and fair in practice."¹⁸⁵ Thus, it is logical to construe the amendments as refashioning the existing practice to the least extent possible consistent with their aim, thereby avoiding the mistake of fixing something which wasn't broken.

182. See, e.g., *Zuber v. Allen*, 396 U.S. 168, 186-87 (1969) (expressing a clear preference for committee reports over floor debates); *Meade Township v. Andrus*, 695 F.2d 1006, 1011 (6th Cir. 1982).

183. *Chrysler Corp. v. Brown*, 441 U.S. 281, 311 (1979) (comments of single legislator, even the sponsor, are not binding or controlling in analyzing legislative history); *Railroad Comm'n v. Chicago, Burlington & Quincy R.R.*, 257 U.S. 563 (1921).

[E]xplanatory statements of members in charge made in presenting a bill for passage have been held to be a legitimate aid to the interpretation of a statute where its language is doubtful or obscure. But when taking the Act as a whole, the effect of the language used is clear to the Court, extraneous aids like this can not control the interpretation. Such aids are only admissible to solve doubt and not to create it.

Id. at 589 (citations omitted); see also *In re Sinclair*, 870 F.2d 1340, 1341-44 (7th Cir. 1989), in which Judge Easterbrook cogently discusses the uses and role of legislative history, concluding:

An opinion poll revealing the wishes of Congress would not translate to legal rules. Desires become rules only after clearing procedural hurdles, designed to encourage deliberations and expose proposals (and arguments) to public view and recorded vote. Resort to "intent" as a device to short-circuit these has no more force than the opinion poll-less, because the legislative history is written by the staff of a single committee and not subject to a vote or veto.

Id. at 1343-44.

184. See *supra* notes 52-97 and accompanying text.

185. The quoted language forms a part of Senator Baucus' statement regarding the amendments to § 303. See 130 CONG. REC. S7618 (daily ed. June 19, 1984) (statement of Sen. Baucus); see also *supra* text accompanying note 99.

A. Determining a Bona Fide Dispute Under Section 303(b)

Given the clear and direct language of amended section 303(b), it is difficult to dispute that by virtue of the 1984 Act Congress overruled the practice established in *In re All Media Properties, Inc.* of including nearly all disputed claimholders in the category of creditors eligible to invoke the bankruptcy court's jurisdiction under section 303(b).¹⁸⁶ However, as recognized in cases decided both before and after enactment of the amendment to section 303,¹⁸⁷ a debtor's primary protection against a non-meritorious petition is and properly should be found in the assessment of whether or not proper grounds for relief exist under section 303(h). Moreover, it bears reiterating that a substantial deterrent against improperly conceived or abusive filings still exists in the form of section 303(i). Therefore, it is a mistake to read the amendment to section 303(b) as authorizing as abrupt a departure from prior practice as achieved by strict application of the tests articulated in either *In re Stroop*¹⁸⁸ or *In re Lough*.¹⁸⁹ There is simply no compelling reason why a creditor should be required to shoulder the heavy burden of proving the absence of any material issue of fact or law bearing on the debtor's liability solely as a condition to having the merits of an involuntary petition heard.¹⁹⁰

The underlying question of the debtor's ultimate liability on any particular creditor's claim, whether disputed or not, is never the matter directly at

186. *In re All Media Properties, Inc.*, 5 Bankr. 126 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981). For a discussion of the *All Media* decision, see *supra* notes 52-74 and accompanying text.

187. See *All Media*, 5 Bankr. at 144 ("[T]he court believes that where a debtor fails to pay a debt which is subject to a bona fide dispute that debt should not be considered a debt which has not been paid as it became due."); *In re Ross*, 63 Bankr. 951, 961 (Bankr. S.D.N.Y. 1986).

188. 51 Bankr. at 210.

189. 57 Bankr. 993 (E.D. Mich. 1986).

190. To be sure, some of the reported decisions which have expressly addressed the matter do indeed suggest that the petitioning creditors bear the burden of establishing their claims for purposes of § 303(b) with a degree of certainty that would warrant summary relief in a conventional civil case. For example, in *In re Hope Communications, Inc.*, 59 Bankr. 939, 943-44 (Bankr. W.D. La. 1986), the court held that the petitioning creditors' failure to establish the absence of a bona fide dispute with regard to their claims against the debtor was grounds to dismiss the petition. See also *In re Charon*, 94 Bankr. 403, 406 (Bankr. E.D. Va. 1988) (petitioning creditor failed to meet its burden of proving that it satisfied the jurisdictional requirements of § 303(b)); cf. *In re Busick*, 831 F.2d 745, 750 (7th Cir. 1987) (debtor's assertion of defenses which raised a reasonable contention "as to the application of law to undisputed facts" was sufficient to render the petitioning creditors' claims subject to a bona fide dispute for purposes of §§ 303(b) and 303(h)(1) (quoting *In re Lough*, 57 Bankr. at 997)); *infra* note 214 and accompanying text (addressing the parallel question of which party bears the burden of proof with respect to the absence of a bona fide dispute element under § 303(h)(1)).

issue at the trial of an involuntary petition.¹⁹¹ Therefore, it is puzzling that the petitioning creditors have been required at any point in the process of obtaining an order for relief to establish the absence of all factual or legal barriers to the debtor's liability on their claims. The rationale becomes even more attenuated in the context of section 303(b) where the purpose for the inquiry into the bona fide dispute issue is much narrower and more limited than the ultimate question of whether or not an involuntary case should go forward. The only question which actually turns on resolution of the bona fide dispute issue for section 303(b) purposes is the more-or-less procedural one of eligibility to invoke the bankruptcy court's jurisdiction.

Viewed from that perspective, it would be consistent with both conventional civil practice and the original legislative history of section 303 to treat the debtor's contradiction of a petitioning creditor's claim as an affirmative legal defense to that creditor's entitlement to maintain suit for involuntary relief. As such, the debtor would ordinarily be responsible not only for challenging the validity of the claim, but would also bear the ultimate burden of showing the existence of a bona fide dispute. In fact, some courts have stated, or at least implied, that the petitioning creditors' burden under section 303(b) is limited to pleading¹⁹² or perhaps even establishing a prima facie case that their claims are not subject to a bona fide dispute, but that thereafter the burden of coming forward with evidence of such a dispute shifts to the debtor.¹⁹³ Presumably, where the debtor is

191. That Congress intended in the original drafting of § 303 to eliminate protracted litigation over involuntary petitions is beyond question. See BANKRUPTCY COMMISSION REPORT, *supra* note 38, at 188; see also *supra* note 39 and accompanying text. It is equally clear that, whatever its effect, the purpose of the 1984 Act's amendment to § 303 was to reinforce, not to deviate from that original intent. See 130 CONG. REC. S7618 (daily ed. June 19, 1984) (statement of Sen. Baucus). Senator Baucus' statement, see *supra* text accompanying note 99, suggests that the amendment corrects a "judicial misinterpretation of . . . congressional intent as to the proper basis for granting involuntary relief." 130 CONG. REC. at S7618.

192. See, e.g., *Equidyne Properties*, 60 Bankr. 245, 247 (Bankr. S.D.N.Y. 1986); see also *In re J.B. Lovell Corp.*, 88 Bankr. 459, 462-63 (Bankr. N.D. Ga. 1988) (petitioner's failure to plead the absence of a bona fide dispute may be waived by the debtor; however, the debtor must affirmatively set forth any affirmative defenses or counterclaims before they will be considered by the court (citing FED. R. BANKR. P. 1018, 7008)); *In re Tikijian*, 76 Bankr. 304, 308 n.9 (Bankr. S.D.N.Y. 1987) (It is essential that the original petition contain the allegation that the petitioner's claims are not the subject of a bona fide dispute.).

193. See, e.g., *In re Garland Coal & Mining Co.*, 67 Bankr. 514, 521 (Bankr. W.D. Ark. 1989) (citing *In re Reid*, 773 F.2d 945 (7th Cir. 1985)); see also *Bartmann v. Maverick Tube Corp.*, 853 F.2d 1540 (10th Cir. 1988), in which the court, while adopting the *Lough* test for determining a bona fide dispute under § 303(b), nevertheless approvingly cited *Garland Coal's* statement regarding allocation of the burden for establishing a bona fide dispute and, for that reason, refused to deny a petitioning creditor's standing where the debtor had failed to "make a clear showing that the [creditor's] debt was time-barred." *Id.* at 1544-45. Thus, the court in *Bartmann*, as has been true in some other instances, simply overlooked the fact that the *Lough* formulation originated as a variation on the *Stroop* test which unequivocally adopted a summary judgment-like standard of proof for the petitioning creditors; cf. *Tikijian*, 76 Bankr. at 315 (the issues raised on a summary judgment motion and the question of whether a claim is subject to a bona fide dispute are not identical).

unable to make this showing, the petitioning creditor's standing would remain intact.

Establishing how the issue is joined and on whom the evidentiary burdens rest does not complete the analysis of the proper standard for identifying a bona fide dispute under section 303(b). The fact still remains that the trial on an involuntary petition is not the proper forum for extensive litigation over individual claims and defenses. Therefore, as the courts have long appreciated, a more mechanical test than adjudication on the merits must be found for evaluating a debtor's challenge to a petitioning creditor's standing which is based on the existence of alleged counterclaims and defenses to the creditor's claim. Happily, such a test is readily and easily available. It involves nothing more than a modification of the primary standards already developed by the courts.

As earlier considered, the *Stroop* court held that a defense to the claim of the petitioning creditor would be sufficient to render the claim subject to a bona fide dispute where such a defense raised issues of fact which would bar judgment in the creditor's favor.¹⁹⁴ The *Lough* court then revised the standard by adding that, even in the absence of factual disputes sufficient to preclude summary judgment, a bona fide dispute could still be created by a meritorious contention as to the proper application of governing legal principles to those facts.¹⁹⁵ These tests are basically sound. Their only drawback is that they are verbally backward in formulation.

A debtor should not be able to avoid bankruptcy and defeat the objectives served by the federal bankruptcy system simply by raising unsubstantiated theories of law, or by averring the minimum factual allegations necessary to avoid summary judgment. Instead, bearing in mind that federal bankruptcy legislation is not designed solely or even primarily to serve the needs and protect the interests of debtors alone,¹⁹⁶ the debtor challenging a petition on this ground should be required to make an extraordinary showing to justify denying a creditor's access to involuntary relief.¹⁹⁷

Accordingly, under a better interpretation of the amendment to section 303(b), the term "bona fide dispute" would be narrowly construed. Unless

194. See *supra* notes 111-12 and accompanying text.

195. See *supra* notes 119-20 and accompanying text.

196. Working for the benefit of both the creditor and the debtor, the federal bankruptcy laws are designed "to take charge of the property of insolvent debtors through proceedings in bankruptcy courts, divide their property among their creditors in proportion to their claims, and grant to bankruptcy debtors discharge from further liability for their debts." A. SELVERSTONE, *supra* note 16, at 2; see also T. JACKSON, *supra* note 14, ch. 1.

197. Some courts have followed this recommendation in practice, but continue to pay homage to the *Lough* summary judgment "plus" test. See, e.g., *In re BDW Assocs.*, 75 Bankr. 909, 913 (Bankr. W.D. Pa. 1987) (court stated that in order for the debtor to prevail on its request for dismissal it must present "sufficient proof to contradict the Petitioning Creditor's claims . . ."), *aff'd*, B.D.W. Assocs. v. Busy Beaver Bldg. Centers, 865 F.2d 65 (3d Cir. 1989); see also *supra* note 193.

the debtor's defenses would be sufficient to entitle the debtor to summary judgment dismissing the creditor's claim as a matter of law, taking into account the status of any pre-petition litigation, the petition would be heard on its merits. In other words, the summary judgment analysis would be transposed from a plaintiff's to a defendant's motion. Furthermore, even when the facts entitling the debtor to such relief are undisputed, the petitioning claimholder should not be rendered ineligible from seeking involuntary relief if that creditor can demonstrate a serious contention as to the application of the governing legal principles to undisputed facts. In this way, the prime goal of the Reform Act, preventing protracted and wasteful litigation over involuntary petitions,¹⁹⁸ would be served without sacrificing the equally important Reform Act objective of making involuntary bankruptcy relief a viable alternative for creditors when prompt and efficient liquidation or reorganization of the debtor's assets is warranted.

Thus, several benefits result from reversing the parties' positions under the existing judicial standards. Additionally, the proposed standard offers a construction of the 1984 amendment to section 303(b) which refines, but does not radically alter, what before the amendment had been a reasonably uniform interpretation of the standing rule for involuntary cases.¹⁹⁹ This result is particularly desirable since that previous interpretation had formed an integral component in the operation of a reformed system governing involuntary bankruptcy which had not only been working, but, concededly, had been working fairly well.²⁰⁰

Certainly, adoption of this approach would be consonant with the holding in *In re Drexler*²⁰¹ that where final judgment had already been entered in the creditor's favor prior to the bankruptcy filing, the debtor's disputes as to either the law or the facts cannot create a bona fide dispute.²⁰² Similarly, as many courts have held both before and after the 1984 amendments to section 303, defenses going solely to the *amount* of a creditor's claim would not be enough to cause such claims to be treated as being the subject of a bona fide dispute.²⁰³ Finally, and also in harmony with the court's reasoning in *Drexler*, counterclaims, even if of substance, would not be enough to cast a petitioning creditor's claim into sufficient doubt to deprive that

198. See generally *supra* note 163.

199. See *supra* note 176 and accompanying text.

200. See 130 CONG. REC. S7618 (daily ed. June 19, 1987) (statement of Sen. Baucus) ("For the most part, Section 303 has proved to be both workable and fair in practice."); see also *supra* text accompanying note 99.

201. 56 Bankr. 960 (Bankr. S.D.N.Y. 1986).

202. See *supra* notes 131-32 and accompanying text. Consistent with the analogy to conventional civil practice, once judgment has been entered, the debtor's "summary judgment motion" would have no place.

203. See generally *In re Covey*, 650 F.2d at 883; *In re Sea Island Resorts*, 82 Bankr. 404, 406 (Bankr. D.S.C. 1987); *In re Braten*, 74 Bankr. 1021, 1022 (Bankr. S.D.N.Y. 1987); *In re Galaxy Boat Mfg.*, 72 Bankr. 200, 202-03 (Bankr. D.S.C. 1986).

creditor of standing to prosecute the case.²⁰⁴ Therefore, a petitioning creditor would be denied standing only where the debtor asserted meritorious defenses which were capable of being established without the need for extensive discovery or an expanded evidentiary hearing.

To be sure, the *All Media* decision had recognized the potential of such "airtight defenses," and indicated a willingness to credit them for section 303(b) purposes.²⁰⁵ However, many of the pre-1984 decisions which relied on *All Media* cited its holding as supporting a rule of blanket inclusion of disputed claims under section 303(b).²⁰⁶ Furthermore, among those courts prepared to distinguish types of disputes, there was certainly no consensus over what kind of defense rose to a level of seriousness sufficient to exclude a claimholder from eligibility to file an involuntary petition.²⁰⁷ In fact, since it was not necessary to the holding in the case, even the *All Media* court itself was less than entirely clear about the types of defenses which might form a valid basis to challenge a petitioning creditor's standing.²⁰⁸

Thus, the proposal advanced above for interpreting amended section 303(b) would clarify the practice for dealing with disputed debts and, without placing creditors in undue jeopardy, would further regulate the filing of truly spiteful or malicious petitions. In so doing, this test would not only continue to give meaning to the new statutory language regarding disputed claims, but would attach a meaning which does not directly contradict the brief legislative history.²⁰⁹ On the other hand, this approach, unlike most of the current standards, would not unduly restrict the bankruptcy courts' jurisdiction over involuntary petitions as the price to be paid for solving a

204. *Accord In re J.B. Lovell Corp.*, 88 Bankr. 459 (Bankr. N.D. Ga. 1988).

205. *See All Media*, 5 Bankr. at 135-36; *supra* notes 59-60 and accompanying text.

206. Several pre-1984 decisions casually cited *All Media* for the proposition that all disputed claimholders were entitled to seek a determination of whether or not grounds for involuntary relief existed. *See, e.g., Semel v. Dill (In re Dill)*, 731 F.2d 629, 631 (9th Cir. 1984) ("The well-reasoned holding of *All Media Properties* was that a bona fide dispute over liability does not render a claim contingent."); *Covey*, 650 F.2d at 881 (holders of disputed claims are not barred from being petitioning creditors); *In re First Energy Leasing Corp.*, 38 Bankr. 577, 581 (Bankr. E.D.N.Y. 1984) (under the analysis in *All Media*, the holders of any of the types of claims enumerated in § 101(4)(A), except those contingent as to liability, qualify to be petitioning creditors under § 303(b)); *In re R.N. Salem Corp.*, 29 Bankr. 424, 428 (S.D. Ohio 1983) (the Code does not bar holders of disputed claims from being petitioning creditors).

207. *See generally supra* notes 73-74 and accompanying text (discussion of the discrepant treatment accorded disputed debts under § 303(b) prior to the 1984 Act).

208. For example, what is conventionally considered as among the most cut-and-dry of legal defenses—that a claim is time-barred by the governing statute of limitations—was itself rejected in *All Media* as a sufficient defense to bar a creditor's participation in an involuntary petition. *All Media*, 5 Bankr. at 140; *see also Bartmann*, 853 F.2d at 1544-45 (limitations defense does not preclude creditor from being a petitioning creditor).

209. While Senator Baucus' statement makes clear that "an involuntary petition could not be based on debts that are the subject of a good-faith dispute between the debtor and his or her creditors . . .," it does not address at all the related issue of which of the parties has the burden of establishing good faith. *See* 130 Cong. Rec. S7618 (daily ed. June 19, 1984) (statement of Sen. Baucus).

problem which, from all outward appearances, had mostly been solved already in the original drafting of section 303.

Finally, and perhaps most importantly, if limited in application to the creditor standing issue, this proposal would not ease the showing that petitioning creditors are required to make in order to obtain an order for relief. It is to that latter, and, as has been repeatedly stressed, separable aspect of the disputed debts question that attention is focused upon next.

B. Determining a Bona Fide Dispute Under Section 303(h)(1)

In contrast to some of the past approaches for dealing with disputed debts under section 303(b), the courts evaluating the merits of involuntary petitions have always given some weight to the debtor's allegations that its unpaid debts were the subject of a good faith dispute. Thus, to a degree not true with respect to section 303(b), the inclusion of the "unless subject to a bona fide dispute" language in section 303(h)(1) can defensively be viewed as codifying, rather than refashioning, prior case law and practice.

Initially it might be tempting to reject such an explanation as falling prey to the cardinal sin in statutory construction of interpreting the statutory amendment in a manner that strips it of any purpose or import. However, that criticism would not be a fair one. Recall that, in *In re Covey*,²¹⁰ the Seventh Circuit adopted an approach for dealing with disputed debts under section 303(h)(1) which required their inclusion except in a very limited category of cases.²¹¹ This extreme view, while not rejected outright, was not warmly endorsed by the other two circuit courts which considered the issue under the original wording of section 303(h)(1).²¹²

In light of the pre-1984 disagreement over the conditions under which disputed debts would be excluded from the generally not paying calculation, it seems sensible to treat the inclusion of the brief, additional statutory language to section 303(h)(1) as doing nothing more than rejecting *Covey* in favor of the more lenient approaches adopted by the Second and Ninth Circuits; both of which entailed an essentially neutral balancing of the competing interests of the debtor and its creditors. Furthermore, this interpretation is perfectly consistent with the sponsor's oration of the reasons

210. 650 F.2d at 877.

211. *Id.* at 883-84. The disputed debts would be excluded only where the dispute: 1) related to the validity of the claim, 2) could be resolved without substantial litigation and 3) where the debtor's interest in avoiding the negative impact of a bankruptcy order for relief outweighed the creditors' interest in preventing a wasteful dissipation of the debtor's assets. See generally *supra* notes 89-93 and accompanying text.

212. See *Dill*, 731 F.2d at 631-32; *B.D. Int'l Discount Corp. v. Chase Manhattan Bank (In re B.D. Int'l Discount Corp.)*, 701 F.2d 1071, 1077 (2d Cir.), *cert. denied*, 464 U.S. 830 (1983).

for and intended operation of the amendment.²¹³ Therefore, ascribing to Congress any more grandiose designs is not only unnecessary, but unwarranted as well.

In practice, this approach would mean that a creditor with standing under section 303(b) would still be required to allege and, if contested, establish that as of the filing date the debtor was generally not paying its non-disputed debts as they came due.²¹⁴ However, satisfaction of the petitioning creditors' burden would be measured under a flexible and liberal standard.²¹⁵ In this regard, "non-disputed" would certainly include debts contested only as to amount,²¹⁶ as well as debts to which liability could be established on a summary basis.²¹⁷ In addition, departing from most of the recent judicially-developed standards, a debt as to which colorable but non-dispositive defenses of fact or law had been raised could be included in the "generally not paying" analysis as well. This follows from the belief that, even as part of the ultimate determination of whether conditions favor administration of the debtor's assets in a bankruptcy proceeding, there is no reason why petitioning creditors should be required to make out a case sufficient to support summary judgment with respect to each of the debtor's admittedly unpaid but disputed debts. On the other hand, because different consequences turn on the determination, there is good reason not to formulate the definition of a bona fide dispute under section 303(h)(1) by simply defaulting to the test developed under section 303(b).

213. Senator Baucus explained that need for the amendment to § 303(h)(1) arises from the fact that "[s]ome courts have interpreted section 303's language on a debtor's general failure to pay debts as allowing . . . the granting of involuntary relief even when the debtor's reason for not paying is a legitimate and good faith dispute over his or her liability." 130 CONG. REC. S7618 (daily ed. June 19, 1984) (statement of Sen. Baucus). While this statement might be fairly viewed as describing *Covey* and its progeny, it is clearly not an accurate statement of the practice for dealing with disputed debts under § 303(h)(1) adopted by, to name but a few, the courts in *All Media, B.D. Int'l Discount Corp.*, or *Dill*. See generally *supra* notes 94-97 and accompanying text. See also *supra* note 175.

214. Most of the cases decided since the amendment of § 303(h)(1) have in fact treated the burden of establishing the absence of a bona fide dispute as an affirmative element of the petitioners' case. See, e.g., *Boston Beverage Corp. v. Turner*, 81 Bankr. 738, 742 (Bankr. D. Mass. 1987); *In re Caucus Distribs.*, 83 Bankr. 921, 931 (Bankr. E.D. Va. 1988); *In re Schiliro*, 64 Bankr. 422, 425 (Bankr. E.D. Pa. 1986). Prior to the 1984 amendment, at least one court had held that proof of a good faith "dispute" had to be established by the debtor. *In re B.D. Int'l Discount Corp.*, 15 Bankr. 755, 764 (Bankr. S.D.N.Y. 1981), *aff'd*, 701 F.2d 1071 (2d Cir.), *cert. denied*, 464 U.S. 830 (1983). However, it was generally acknowledged that the petitioning creditors were otherwise allocated the burden of establishing the debtor's non-payment of its current debts. See, e.g., *In re Nar-Jor Enters.*, 6 Bankr. 584, 586 (Bankr. S.D. Fla. 1980). Compare *supra* notes 190, 192-93 and accompanying text (discussing allocation of the burden of proof under § 303(b)).

215. See *Caucus Distribs.*, 83 Bankr. at 921 (and authorities cited therein); see also *In re Taylor*, 75 Bankr. 682 (Bankr. N.D. Ill. 1987), discussed *infra* note 222 and accompanying text.

216. See authorities cited *supra* note 203.

217. Such debts would of course be included even under the current standards for defining the existence of a bona fide dispute. See, e.g., *In re Busick*, 831 F.2d 745 (7th Cir. 1987).

In a case where the debtor challenges the validity of a matured debt upon which the creditor relies for relief, there would be no absolute rule of inclusion or exclusion,²¹⁸ or even a bias one way or the other. Instead, the judgment would be made on a case-by-case basis in which the court would be principally guided by the underlying policies of bankruptcy law.²¹⁹ Rather than considering the merits of the competing claims or defenses, courts would take into account the inherent tension between an innocent debtor's interest in being free from the havoc wreaked by a non-meritorious petition and the creditors' equally compelling interest in obtaining the protections and safeguards afforded by bankruptcy relief before the debtor's assets have been irretrievably dissipated.²²⁰

It should be apparent that this suggested interpretation of amended section 303(h)(1) attributes to Congress a very limited and unambitious objective in amending the statute; that of responding to the criticism leveled at *Covey* by the Ninth Circuit and others of leaning "too heavily toward favoring creditors", as opposed to debtors', interests."²²¹ However, given the prevailing state of the law at the time of enactment of the 1984 Act, this construction is a sound one. Unlike the more expansive judicial interpretations, this reading of amended section 303(h)(1) avoids the potential for a debtor to frustrate both its creditors and bankruptcy policies simply by raising unproven allegations disputing the existence or validity of its unpaid claims.²²²

218. To this point, this approach would be consistent with the view of the court in *Covey* that "policy considerations . . . do not unanimously support [a universal rule of] either exclusion or inclusion of disputed debts from the 'generally not paying debts' calculation." *Covey*, 650 F.2d at 882.

219. See, e.g., *In re Arker*, 6 Bankr. 632, 636 (Bankr. E.D.N.Y. 1980) ("[T]he purpose of an involuntary proceeding . . . is to secure an equitable distribution of the assets of the alleged debtor among all his creditors.").

220. The importance of continuing to balance the tension which exists between the need to protect creditors and the potential harm to the targeted debtor was recognized by the court in *In re Johnston Hawks, Ltd.*, 49 Bankr. 823, 830-31 (Bankr. D. Haw. 1985), and, to a lesser extent, by Judge Abram in *Drexler and Ross*. See *supra* notes 139, 149 and accompanying text.

221. *Dill*, 731 F.2d at 632; see also *Salem*, 29 Bankr. at 429.

222. In *Salem*, the court stated: "it was not the intention of Congress that a debtor be able to avoid bankruptcy by merely disputing the existence or amount of a claim." *Salem*, 29 Bankr. at 429. While that observation was made before the amendment to § 303, there is no basis in the legislative history or elsewhere to indicate that by amending the statute Congress was now manifesting such an intention.

The problem of debtors disputing debts merely to avoid bankruptcy is more than a purely hypothetical one. The District Court for the Northern District of Illinois recognized exactly this concern in upholding the bankruptcy court's finding that a creditor's debt was not the subject of a bona fide dispute in the absence of presentation of "convincing evidence of a bona fide dispute" by the debtor. *Taylor*, 75 Bankr. at 684 ("otherwise any debtor could defeat an involuntary petition under § 303(h)(1) by merely asserting that a bona fide dispute exists."). While the court did not elaborate on what would suffice as "convincing evidence," quite obviously this standard would entail something considerably more than the minimal allegations necessary to avoid a summary judgment.

On the other hand, there is much more at stake in including disputed debts for purposes of section 303(h)(1) than is true under section 303(b). The finding that the debtor is generally not paying his debts ordinarily means that he will be placed in an involuntary bankruptcy proceeding. Therefore, for the purposes of this inquiry, unlike under section 303(b), no distinction should be made between defenses, and setoffs or counterclaims. In many instances, the facts supporting a counterclaim could also form the basis of a valid defense.²²³ Consequently, when any explanation for non-payment is offered, it should be factored into the analysis by the court and, if of substance, credited accordingly.

Finally, because the appropriateness of bankruptcy relief is at issue, rather than simply the objective merits of the claims and defenses, the court should be able to factor into the balance the consideration of whether the debtor's claims and defenses are being asserted in good faith.²²⁴ A "bona fide" assertion is commonly defined as one made with honest, genuine and earnest intent.²²⁵ Therefore, the requirement that a debtor's defense constitute a bona fide dispute to a matured debt in order to have that debt excluded from the generally not paying analysis should be viewed as equivalent to the requirement imposed by section 303(i) that the creditor's petition not be filed in "bad faith." In the latter inquiry, it is well settled case law that courts consider the creditor's subjective motivation for filing, in addition to making an evaluation of whether the creditor exercised reasonable care in making the decision to initiate involuntary proceedings.²²⁶

Permitting a court to consider good faith is not to suggest that a counterclaim or defense with little or no objective merit might alone be

223. See also FED. R. BANKR. P. 1011(d) ("A claim against a petitioning creditor may not be asserted in the answer except for the purpose of defeating the petition.").

224. The proposal that the court consider subjective good faith under amended § 303 was originally advanced in *Johnston Hawks*, reasoning by analogy to the pre-1984 case law under § 303(h)(1). *Johnston Hawks*, 49 Bankr. at 831. Recall, however, that *Johnston Hawks* was addressing the issue in the context of a challenge under § 303(b). See *supra* notes 103-07 and accompanying text. The case was subsequently criticized and rejected on the basis that it could operate to disqualify a creditor even when the debtor's defense had little or no objective merit. See, e.g., *Lough*, 57 Bankr. at 996-97; *Drexler*, 56 Bankr. at 966-67.

225. See *Ross*, 63 Bankr. at 960 (citing BLACK'S LAW DICTIONARY 223 (Rev. 4th ed.)); see also *In re Nargassans*, 103 Bankr. 446, 449-50 (Bankr. S.D.N.Y. 1989), in which one court acknowledges that this language suggests an inquiry into the subjective intent of the debtor, but then declines to do so on the strength of a strained construction of the term "good faith"; that in this context it relates solely to the due inquiry standards of Federal Rule of Bankruptcy Procedure 9011.

226. See, e.g., *In re Turner*, 80 Bankr. 618 (Bankr. D. Mass. 1987); *U.S. Fidelity and Guar. Co. v. DJF Realty & Supplies*, 58 Bankr. 1008 (Bankr. N.D.N.Y. 1986); *Basin Elec. Power Coop. v. Midwest Processing Co.*, 47 Bankr. 903 (Bankr. D.N.D. 1984), *aff'd*, 769 F.2d 483 (8th Cir. 1985), *cert. denied*, 474 U.S. 1083 (1986); see also *Johnston Hawks*, 72 Bankr. at 367 n.2 (in the final analysis, the objective test is really a subjective one since the question of whether or not a party has acted in bad faith is a question of fact to be decided by the court).

sufficient to sustain or defeat an involuntary petition.²²⁷ It simply means that the courts should be instructed to, as in many cases they actually do anyhow,²²⁸ consider a broad range of factors when deciding whether to enter an order for bankruptcy relief. Moreover, under this approach courts could sustain jurisdiction over a petition when it appeared that the debtor's defenses, while facially of substance, were interposed merely for purposes of delay or to unfairly favor one creditor over others.²²⁹

The neutral and open-ended balancing test proposed above for addressing disputed debts in connection with the "generally not paying" issue is similar to approaches adopted by some courts as an alternative to *Covey* even prior to the amendments.²³⁰ It is also a compatible extension of the balancing analysis recommended by Judge Abram in *Drexler* and *Ross* as a final test to be performed before entering an order for relief in an involuntary case. Like Judge Abram's test, the proposed test would serve as a means of ensuring that the doctrinal result reached by formalistic application of

227. This is essentially the concern that accounted for the *Lough* court's rejection of the inquiry into "good faith," "fraud" and "deceit," as mandated by *Johnston Hawks*. *Lough*, 57 Bankr. at 996. However, as noted, it remains more than a little anomalous to exclude consideration of a debtor's good faith in making a determination which is expressly made dependent on the "bona fides" of the alleged dispute to payment.

228. Notwithstanding the way the *Stroop* and *Lough* tests are formulated in terms of putting the burden of showing conditions sufficient to warrant summary relief on the petitioning creditors, it is arguable that, as a practical matter, the bankruptcy courts do overlook alleged legal and factual disputes in situations where the petitioners' right to relief seems clear and the debtor's alleged disputes seem, if not patently frivolous, at least too coincidentally self-serving. See *Tikijian*, 76 Bankr. at 304 (debtor's allegations of collateral agreements and understanding regarding debtor's liability on contracts of guarantee held not to qualify as bona fide disputes); *In re BDW Assocs.*, 75 Bankr. at 909 (petitioners held eligible to seek relief even though their claims against the debtor were dependent on a finding that the debtor was the alter ego of an entity to whom the petitioning creditors had sold materials and supplies). Similarly, in *In re Albers*, 71 Bankr. 39, 42 (Bankr. N.D. Ohio 1987), the court refused to credit the debtor's allegations that one of the petitioning creditor's judgment liens had been fraudulently procured. See also discussion *supra* note 173.

229. This scenario is the situation which prompted the *Lough* court's concern over giving into subjective motivation. See *Lough*, 57 Bankr. at 996-97; *supra* note 118. However, it also presents an equally compelling illustration of a circumstance where entitlement to involuntary relief should not be denied because of a purely technical application of the governing standard. In his explanation for the 1984 amendments to § 303, Senator Baucus expressly identifies a concern over debts which have not been paid due to a "legitimate and good faith dispute." See *supra* note 213. If the debtor's "good faith" in contesting liability weighs in the debtor's favor, then in all fairness "bad faith" should count against him.

230. See *In re Dill*, 731 F.2d 629, 632 (9th Cir. 1984); *Salem*, 29 Bankr. at 430 (rejecting adoption of the *Covey* standard on the basis that it placed too much weight in favor of the creditors' interests); see also *supra* notes 94-97. The position of these courts might have been legitimately questioned at the time because of the absence of any suggestion in § 303 that debts subject to a bona fide dispute were properly excludable in analyzing entitlement to involuntary relief. Under the current version of § 303(h)(1) that type of criticism can no longer be seriously entertained. Paradoxically, therefore, these cases may be even more defensible now than they were at the time they were decided.

general rules to particular facts does not impinge on broader underlying policy considerations.²³¹

To be sure, a rule which requires balancing of competing interests based upon consideration of a wide range of factors lacks the certainty and predictability which a more mechanical rule would provide.²³² However, it would be wrong to read the new statutory language to section 303(h)(1) as providing any such specific guidance. Such a scopic interpretation is not supported by either the brief legislative history or the actual experience which preceded the amendment. Additionally, the language of the amendment is not fairly susceptible to any more generalized formulation except perhaps for one which would unduly favor debtors' interests by forcing creditors in every controverted case to perform the nearly insuperable task of making a case on the debtor's liability to them strong enough to justify a summary judgment.²³³ Actually, that requirement becomes even more draconian under section 303(h)(1) than under section 303(b) since it potentially entails subjecting the petitioning creditors to that kind of rigorous burden not only with regard to their own debts, but also as to the debts of other non-petitioning, unpaid creditors whose claims the debtor casts into dispute through assertion of alleged defenses and offsets. Such a radical departure from prior practice, with a consequent narrowing of creditors' rights to obtain bankruptcy relief, could not have truly been the intent of Congress in adding six short words to section 303(h)(1).

In sum, if the court in *Covey* erred by tipping the balance too heavily in creditors' favor, it would be an equally unhealthy mistake to construe the 1984 amendment to section 303(h)(1) as doing anything more than restoring that balance. Over the course of the normal common law process a consensus might eventually develop which would provide basic guidelines concerning the bona fides of some kinds of defenses in certain procedural contexts. *Drexler* might even be viewed as the beginning of such a process. However, because the purposes of involuntary bankruptcy are multifarious in nature, and the circumstances which call for its initiation are diverse in origin, it may be impossible to ever fully relieve the bankruptcy courts of the responsibility for making a particularized analysis in every case.

The operation of the proposed approach for defining a bona fide dispute under sections 303(b) and 303(h)(1) will be illustrated by a hypothetical. Consider an unpaid seller of goods on credit who petitions for involuntary

231. See generally *supra* notes 131-40 and accompanying text.

232. See *Dill*, 731 F.2d at 632 ("Inclusion of disputed debts in the § 303(h)(1) generally not paying debts calculation involves difficult policy evaluations with little legislative guidance.").

233. This is the interpretation which troubled the court in *Taylor*, 75 Bankr. at 684. Yet, by construing the 1984 amendment to § 303(h)(1) in a manner which makes the assertion of unproven counterclaims and defenses not just a factor but, for all intents and purposes, the determinative variable in deciding whether an overdue debt will be considered unpaid, the *Lough/Busick* standard presents precisely this danger.

bankruptcy. The debtor responds with defenses based upon the alleged non-conformity of the goods to the contract description. Prior to the 1984 amendments, the seller almost certainly had standing to invoke the bankruptcy court's jurisdiction. However, under most of the current standards, that same creditor's standing is in serious jeopardy unless his claim has already been finally adjudicated in state court. By contrast, under the modified standard recommended above, standing would exist under section 303(b) unless the debtor's defense to liability could be established without resolving either disputed questions of fact or substantial doubts about the application of governing non-bankruptcy law to those facts.

Assuming the petition were to proceed to trial, under *Covey* the seller's claim would almost undoubtedly be included for purposes of determining whether the debtor had ceased paying his matured debts. Alternatively, under current precedent, the claim will almost certainly be excluded in evaluating the question of the petitioning creditor's right to relief.²³⁴ In contrast, under the alternate test proposed above, the issue would have to be resolved by the bankruptcy court taking into account the totality of surrounding circumstances including, but not limited to, whether the debtor's legal position has any objectively determinable legal merit.²³⁵ However, in making its ultimate decision, the court would ultimately be guided by considerations of whether or not the creditor's interest in an orderly procedure for liquidation of the debtor's assets outweighs the debtor's interest in remaining free from the stigma and consequences of a bankruptcy proceeding. In this connection, just as the creditor's good faith in seeking relief is made relevant by section 303(i), the exclusion under section 303(h)(1) for debts subject to "bona fide" dispute means that the debtor's motivations in raising counterclaims and defenses must be examined as well. While it is, of course, impossible in this hypothetical context to predict the outcome of that process, the debtor and the creditors would at least be assured that the decision of whether an order for relief should enter under section 303 would be made with explicit regard for both the objectives and the limitations of involuntary bankruptcy.

CONCLUSION

A fair and evenhanded system of involuntary bankruptcy would result from untying the standards for defining a bona fide dispute under sections

234. In reality, of course, if the *Lough/Busick* standard governs, that latter determination is probably never actually made since preliminary application of the same standard for § 303(b) purposes likely results in dismissal of the petition on jurisdictional grounds and moots the second inquiry.

235. See *In re Ross*, 63 Bankr. at 960 (articulating the existence of "any genuine and objectively determinable legal merits" as an operative factor in the bankruptcy court's analysis of the bona fide legal dispute issue).

303(b) and 303(h)(1) and reformulating the test for each in a manner sensitive to the particular inquiry being made. As noted, this would entail less of a break with past practice than the interpretation which, for the most part, the courts have attached to date. Also, this approach would clarify and in some ways refine the judicially-created gloss on the original 1978 version of the statute, without simultaneously requiring a wholesale abandonment of five years of productive case law development. More importantly, application of these standards for determining when a debtor's dispute to a particular claim or debt will be regarded as a bona fide dispute under section 303 would not necessitate the dismantling of a basic statutory system which was deliberately and carefully crafted to strike a fair balance between the interests of debtors and their creditors.

As the review of post-1984 Act case law has shown, there is no less ambiguity and uncertainty about the role and impact of disputed debts in involuntary bankruptcy proceedings since the amendment of section 303 than before. Consequently, there is room, and arguably need, for further refinement and development in the standards for defining a bona fide dispute. In undertaking this task and attempting to rationalize the confused state of the current case law, the courts should be less beholden to unsubstantiated concerns over inequities in the system, and more sensitive to the fundamental bankruptcy policy of ensuring the fairest and most equitable distribution of limited assets among competing claimants. It is with that view in mind that the foregoing proposals have been offered and it is hoped that it will be in that spirit that they are examined and critiqued.

